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In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. Whether courts should enforce indemnity clauses in stock purchase agreements in which buyers agree to indemnify sellers for any losses, including attorneys' fees, arising from the untruth of any of the buyers' representations?

2. Whether courts should apply normal state law contractual standards to such indemnity clauses as was done in *Samuels v. Wilder,* 871 F.2d 1346 (7th Cir. 1989), and similar cases, or should they instead apply a special federal standard of narrow construction against sellers of securities whenever buyers allege federal securities claims, as was done in *Zissu v. Bear, Stearns & Co.,* 805 F.2d 79 (2d Cir. 1986), and *Layman v. Combs,* 994 F.2d 1344 (9th Cir. 1993)?

3. Whether courts should enforce stock buyers' representations and warranties that they have "received no representations or warranties from the Sellers . . . other than those contained in the [Private Placement] Memorandum"?

4. "May sophisticated, well-counselled parties, using disposable assets, dealing at their leisure and from arms' length, limit by contract what information they will consider in making a major investment?", *Layman v. Combs,* 994 F.2d 1344, 1357 (9th Cir. 1993) (Kozinski, J., dissenting).

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PETITIONERS,

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CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners FRANK L. BRYANT, KEMPER SECURITIES, INC. (formerly known as BATEMAN EICHLER,

HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C.,[1] respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, originally filed in the above-entitled case on December 17, 1992, and amended on May 12, 1993.

REPORTS OF OPINIONS DELIVERED BELOW.

The amended opinion of the Ninth Circuit, *Layman v. Combs,* 994 F.2d 1344 (9th Cir. 1993) ("*Layman*") and the dissent of Circuit Judge Alex Kozinski are reprinted in the appendix at A-1.

The original opinion of the Ninth Circuit and the Kozinski dissent in *Layman v. Combs* were published at 981 F.2d 1093 (9th Cir. 1992). The underlying opinion and order of the United States District Court for the Northern District of California, *Stratmore v. Combs,* 723 F. Supp. 458 (N.D. Cal. 1989), are reprinted in the appendix at A-36.

The Ninth Circuit issued two other published opinions in this case: *McGonigle v. Combs,* 968 F.2d 810 (9th Cir.) (deciding the case on the merits), *cert. dismissed,* 113 S. Ct. 399 (1992) ("McGonigle"), and *Schultz v. Hembree,* 975 F.2d 572 (9th Cir. 1992) (reversing an inadequate award of attorneys' fees under Florida and Ohio fee-shifting statutes) ("Schultz").

The opinion in a related federal court case involving the same issues and the same indemnity clause but coming to a different result from the *Layman* majority, *Brownell Combs II v. Zenya Yoshida,* No. 90-131 (E.D. Ky. filed

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[1] Kemper Securities, Inc. is a subsidiary of Kemper Corp., and Kincaid, Wilson Schaeffer & Hembree, P.S.C. has no parent or subsidiary.

June 4, 1993) ("*Combs*"), is reprinted in the appendix at A-51.

STATEMENT OF JURISDICTION.

The judgment in the Court of Appeals was originally entered on December 17, 1992, and a timely petition for rehearing was denied on May 12, 1993. The Ninth Circuit filed an amended opinion on May 12, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1992).

STATUTES INVOLVED.

(The text of each is set forth in the appendix.)

The Securities Act of 1933, § 11, 15 U.S.C. § 77k(e) (1993)

The Securities Exchange Act of 1934, § 29(a), 15 U.S.C. § 78cc(a) (1993).

CONCISE STATEMENT OF THE CASE.

A. Summary of the Proceeding Below

This petition emanates from the August 1983 private placement of stock in Spendthrift Farm, Inc. (the "Farm"), reputed to be the largest private placement to individuals in United States history. The litigation spawned five reported decisions, four in the Ninth Circuit, and one in the Northern District of California.[2]

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[2] As Judge Kozinski stated in his dissent in *Layman*, "Much is at stake here for everyone involved. This litigation -- although it resulted in a complete defense victory, mostly on summary judgment -- devoured a staggering quantity of productive resources. The record consists of 50 cubic feet of paper and weighs over half a ton. There were 4500 entries in the docket sheets below, including almost 400 orders and rulings by the district court. Fifty-seven briefs, consisting of nearly 1800 pages, were filed on appeal. . . ." *Layman*, 994 F.2d at 1358, App. at A-32.

The *same* indemnity clause construed by the Ninth Circuit in *Layman* was shortly thereafter interpreted differently using normal state law principles in *Brownell Combs II v. Zenya Yoshida,* No. 90-131 (E.D. Ky. filed June 4, 1993). The *Layman* majority opinion generated a strong dissent by Ninth Circuit Judge Alex Kozinski and a Harvard Law Review Comment[3] criticizing the majority's reasoning.

The Farm bred thoroughbred horses in Lexington, Kentucky. At the time of the private placement, the Farm was considered to be the "IBM" of horse breeding farms. Triple Crown winner Seattle Slew was only one of the Farm's stud horses.

This Petition relates to seven consolidated lawsuits initially brought by some of the investors in the private

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[3] Comment, *Securities Laws - Disclosure Liability - Ninth Circuit Declines to Rule on Whether Investors May Indirectly Waive Misrepresentation Claims Against Securities Issuers - Layman v. Combs, 981 F.2d 1093 (9th Cir. 1992)*, 106 Harv. L. Rev. 1697 (1993).

placement.[4] In all, fifteen plaintiffs sued fifteen defendants on over a dozen claims for relief.

The Petitioners are Frank L. Bryant (a Farm director and financial consultant), Kemper Securities, Inc. (formerly known as Bateman Eichler, Hill Richards, Inc.) (the Farm's investment banker), Charles R. Hembree (the sellers' and Farm's attorney) and Hembree's law firm. All defendants consistently denied wrongdoing and were vindicated below.[5]

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[4] Less than half the private placement investors sued. Most of the investors, two of whom were Alger B. Chapman, the former head of American Express, and Vern Winchell, the founder of Winchell's Donuts and former Chariman of the Board of Denny's Inc., never sued anybody for anything arising out of their purchases of Farm stock. The cases involved in this petition were filed in 1986-87: the *Stratmore* action, filed in February 1986; *Layman*, filed in March 1986; *Griggs*, filed in June 1986; *Yoshida*, filed in July 1986; *McGonigle*, filed in July 1986; *Schultz*, filed in August 1986; and *Casares*, filed in July 1986. These cases and several others were deemed related under the rules of the Northern District of California and assigned to the Honorable Charles A. Legge. The *Schultz* case, filed in the Southern District of Ohio, and the *Casares* case, filed in the Southern District of Florida, were transferred for pretrial purpose to the Northern District of California by the Judicial Panel on Multi-District Litigation. In October 1988, Judge Legge granted defendants' motions for change of venue to the Northern District of California in these actions. All of these cases were ultimately tried before Judge Legge.

[5] Other defendants not parties to this petition include the following: Leslie Combs II, the founder of Spendthrift and one of two sellers of stock in the private placement; Brownell Combs II, Leslie's son and also a seller in the private placement; Garth Guy, who put together the private placement on behalf of the Combses; Curtis Green and Ronald C. Ewart who allegedly helped Guy sell the offering; Richard F. Broadbent III and Bloodstock Research and Information Services, Inc., whose appraisals of the Farm's equine assets appeared in the Private Placement Memorandum; the Farm itself, which was sued in several of the cases; and Central Bank & Trust Co. of Lexington,

(continued...)

The plaintiffs sued a "stable full of defendants but lost on every claim."[6] Defendants' success on the merits, however, threatens to become only a Pyrrhic victory. As Judge Kozinski stated in his dissent,

> The case of Frank Bryant, a Spendthrift consultant, is particularly alarming. His defense was that he joined Spendthrift *after* the sale of the shares and was not in any way involved in the conception or drafting of the PPM. Defending on this theory, and winning summary judgment, Bryant was nonetheless saddled with approximately $900,000 in legal fees. If this is the face of victory, how much uglier could defeat be?

Layman, 994 F.2d at 1358 n.3, App. at A-33 (emphasis added and citation omitted).

The petitioners counterclaimed against plaintiffs based on plaintiffs' breaches of a stock subscription agreement (the "Contract"), which is reprinted in the appendix at A-71. Petitioners sought indemnification of all their expenses, including attorneys' fees.[7] Petitioner Bryant also sued for

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[5](...continued)
which lent money to various private placement investors for the purpose of purchasing the Farm's stock and was sued in a few of the cases.

[6] *Schultz v. Hembree*, 975 F.2d 572, 574 (9th Cir. 1992).

[7] In *Alyeska Pipeline Service Co. v. The Wilderness Society*, 421 U.S. 240, 247 n.18 (1975), this Court recognized that for centuries "the courts of England were authorized to award counsel fees to successful plaintiffs in litigation." It also stated the general "American rule" that "absent statute or enforceable contract, litigants pay their own attorneys' fees." *Id.* at 257. *Alyeska* refused to judicially expand fee-shifting, preferring the course of judicial restraint and deference to the voluntary (continued...)

negligent misrepresentation based upon the plaintiffs' untrue representations.

Plaintiffs moved for summary judgment on the counterclaims. The district court granted the motions and entered judgment for plaintiffs on the counterclaims. The Ninth Circuit affirmed, construing the indemnity clause against the sellers so as to avoid (what the majority termed) an "absurd" result which would have resulted from enforcing the plain meaning of the Contract. *Layman*, 994 F.2d at 1352, App. at A-18.

B. Statement of Facts

Plaintiffs were wealthy and sophisticated investors[8]

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[7](...continued)
agreements of parties and the enactments of legislators. Since *Alyeska*, Congress and State legislatures have enacted hundreds of fee-shifting statutes. *See* Richard Larson, *Federal Court Awards of Attorneys' Fees* (1981), and California Continuing Education of the Bar, *California Attorneys' Fees Award Practice* (1982). Parties, of course, have entered into thousands of voluntary fee-shifting agreements as *Alyeska* authorized them to do.

[8] Each investor represented that he had a net worth of five million dollars at the time of the private offering, but several of them including Calvin Klein, Kenneth Franzheim and Zenya Yoshida were reputed to be worth over fifty million each. Plaintiffs gained their wealth and sophistication in a variety of contexts. Plaintiff Calvin Klein and his lifelong business partner Barry Schwartz made millions in jeans and perfume before going into the thoroughbred horse business and they hired a CPA with a masters in taxation from New York University law school to evaluate the private offering for them. Blas Casares was on the Central Intelligence Agency payroll in a top secret mission in Cuba at the time of the Bay of Pigs and made his millions in commodities trading in South America. Plaintiff Franzheim made a fortune in oil and gas before being appointed United States Ambassador to New Zealand. Plaintiff Schultz made tens of millions building one of the nation's

(continued...)

who alleged that the defendants misled them into buying Farm stock. Some plaintiffs bought over $2,200,000 of stock and their average investment was over $1,000,000 per plaintiff. The plaintiffs included:

1. Calvin Klein, New York
2. George E. Layman, Jr., Washington State
3. Zenya Yoshida, dba Shadai Farms, Japan
4. Kenneth Franzheim, II, Texas and Kentucky
5. Blas R. Casares, Florida and Venezuela
6. Earl H. Shultz, California
7. Richard L. Schultz, Ohio
8. Virginia M. McGonigle, California
9. John F. McGonigle, California
10. H. James Griggs, California
11. George E. Layman, Washington State
12. Barry K. Schwartz, New York
13. Forest Acres Partnership, a Washington State general partnership
14. Barry K. Schwartz Partnership, a New York general partnership
15. Robert D. Stratmore, California

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[8](...continued)
largest debt collection agencies. Plaintiff Griggs was financial advisor to the pension plan of California's state employees. Plaintiff Stratmore was an associate at Pillsbury, Madison & Sutro, one of California's largest law firms before he was suspended from the practice of law by the California Supreme Court for defrauding 11 New York law firms in *Stratmore v. State Bar of California,* 14 Cal. 3d 887, 123 Cal. Rptr. 101, 538 P.2d 229 (1975).

The plaintiffs had substantial experience with horse breeding. Most retained independent investment advisors and lawyers and took their time considering the investment. "Typical is Robert Stratmore, an attorney who specialized in equestrian law and transactions, who grossed more than $15 million in thoroughbred trading the year of the Spendthrift offering and who holds lifetime breeding rights to Triple Crown winner Seattle Slew." *Layman*, (Kozinski dissent), 994 F.2d at 1356 n.1, App. at A-28. Other plaintiffs "included international fashion mogul Calvin Klein; Zenya Yoshida, Japan's biggest and most prominent horse breeder; and the Layman family, who has been involved with thoroughbred horses for thirty years." *Id.*, App. at A-29. Obviously, "[t]hese weren't mom and pop investors. . . ." *Id.* at 1356, App. at A-28.[9]

The plaintiffs bought stock from Leslie Combs and Brownell Combs (the "sellers") in the sellers' 1983 private placement of Farm stock. In connection with the purchase each plaintiff executed a Contract which promised:

> to indemnify [defendants] against any losses, claims, damages, liabilities, *expenses (including attorneys' reasonable fees* and disbursements) judgements and amounts paid in settlement *resulting from the untruth* of any of the warranties and representations contained herein, or the breach . . . of the covenants made by him herein.

---

[9] Judge Kozinski noted these facts when he wrote in exasperation, "Under these circumstances, what on earth does it mean to say the subscribers didn't have notice of the attorneys' fee indemnity clause? . . . If these subscribers can't be held to the terms of the contract they signed, who ever can? *Id.* at 1357, App. at A-29, A-30.

Contract, para. 5, App. at A-78 (emphasis added).

Each Contract contained a warranty and representation that the buyer had read the Private Placement Memorandum ("PPM") and that the buyer was not relying on any representations other than those in the PPM.

Three years later, after a dramatic downturn in the market for thoroughbred horses, the plaintiffs brought suit against the defendants for common law tort claims and violation of several state statutes, federal RICO, and federal securities laws, including failure to register a public offering (alleging that the sellers' so-called "private offering" of Farm stock was in reality a "public offering").[10] The defendants included the private placement's two sellers, the lawyers for the sellers and the Farm, the sellers' horse appraisers, the private placement promoter, one of the Farm's directors, the Farm's investment banking firm, the Farm's commercial bank, and the Farm's outside accountants.

As the *Layman* panel stated in its related opinion, *Schultz v. Hembree,* 975 F.2d 572, 576 (9th Cir. 1992):

> We live in a society which, unfortunately, sanctions the view that litigation is a proper response to many of life's hard knocks. Lawyers capitalizing on this phenomenon often multiply unnecessarily the number of legal theories under which suit is brought. The result in many cases is shotgun litigation: a barrage of claims, emanating

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[10] Marc H. Morgenstern, *Private Placement Guidelines -- A Lawyer's Letter to a First-time Issuer,* 48 The Bus. Law. 257 (1992), summarizes current federal securities law governing private placements.

from a point source and fanning out in the hopes of wounding someone in the process.

Plaintiffs made numerous allegations concerning the private placement which left no doubt that their own representations and warranties were false. The following examples are illustrative:

What Plaintiffs Said In Their Contract

1. Plaintiffs *received no representations* from the sellers other than those in the PPM. (¶4(n).)

2. Plaintiffs *understood* that the financial information in the PPM is "unaudited" and "no provision has been made for deferred taxes." (¶4(v).).

3. Plaintiffs *understood* that there were restrictions on the transferability of the stock, that there will be no market for the shares, and it may not be possible to liquidate the investment. (¶4(h).)

What Plaintiffs Said In Their Complaints[11]

1. Plaintiffs relied on numerous untrue *oral* representations. (¶¶40, 51.)

2. Plaintiffs were *misled* because the financial information in the PPM failed to conform to generally accepted accounting principles and made no provision for deferred taxes. (¶36(a)(v).)

3. Plaintiffs were induced to purchase stock by *oral misrepresentations* that they would have an opportunity to "cash out" of the deal. (¶50.)

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[11] All paragraph references are to the First Amended Complaint in the *Layman* action, which served as a model for the other plaintiffs' complaints.

Plaintiffs freely admitted at trial that their representations and warranties were untrue. For example, as to their reliance on oral representations:

* Plaintiff Calvin Klein's CPA financial advisor and tax lawyer, Ralph Finerman, testified that he relied upon oral representations made by defendants Guy and Hembree.

* Plaintiff Layman testified that he relied on oral representations made by defendants Hembree and Guy.

* Plaintiff Schultz testified that he relied upon oral representations by Luther Deaton of Central Bank.

* Plaintiff Griggs testified that he relied upon oral representations made by defendant Guy.

* Plaintiff Casares testified that he relied heavily on oral representations made to him by defendant Hembree.

Moreover, as is often true in high-stakes litigation, defendants incurred large expenses. Defendants incurred millions of dollars in attorneys' fees in successfully defending these suits.[12] Through their counterclaims, defendants

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[12] Judge Kozinski's dissent noted that "[t]he attorneys' fees, for the seven defendants who requested them, amounted to more than $3.5 *million*." *Layman*, 994 F.2d at 1358, App. at A-32 (emphasis in original). Attorneys' fees were not, however, the only losses suffered: Bryant alleged in his counterclaim that he suffered emotional distress and loss of reputation as a result of plaintiffs' untrue representations and warranties.

sought reimbursement for the losses they incurred by reason of the untruth of plaintiffs' representations and warranties.

REASONS FOR GRANTING THE WRIT

I.

THE CIRCUIT COURTS CONFLICT IN CONSTRUING INDEMNITY CONTRACTS BY BUYERS OF SECURITIES AS TO WHETHER TO (A) APPLY TRADITIONAL STATE LAW CONTRACTUAL INTERPRETATION PRINCIPLES, OR (B) CREATE A FEDERAL RULE OF NARROW CONSTRUCTION AGAINST SELLERS OF SECURITIES.

The prime reason certiorari is appropriate in this case is the conflict between certain recent circuit court decisions which "federalize" indemnity contract interpretation in stock fraud cases and the majority of federal cases which apply state law to decide the plain meaning of such contracts.

Federal cases are split in their approach to indemnity provisions agreed to by buyers. The only "trend" surfacing, however, is confusion. A new line of federal cases, while acknowledging that indemnity provisions are generally enforceable have refused to enforce them for want of specificity.

A. The Majority of Federal Cases Apply Traditional State Law Contract Interpretation Rules.

Most federal courts apply traditional rules of contract interpretation to indemnity clauses contained in stock purchase agreements. In contrast, a seminal recent case, *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75 (2d Cir.

1986), consciously refused to apply state law contractual interpretation principles to indemnity contracts in securities cases. *Layman* followed *Zissu* in creating a new federal rule to apply against stock sellers in indemnity cases.

The traditional rule is best illustrated by *Samuels v. Wilder,* 871 F.2d 1346 (7th Cir. 1989).

Samuels enforced a counterclaim for indemnity in a securities fraud case. *Samuels* applied traditional contract law principles to give meaning to the indemnity clause. The indemnity clause obligated the buyer of stock to "hold [seller] harmless from all liability, loss, expenses, damages, costs and attorneys' fees that [seller] may at any time incur by reason of any type of inquiry, action or suit which may be brought against him . . . by reason of the [relationship]." *Samuels v. Wilder,* 871 F.2d at 1348. The court noted that the sophisticated securities purchaser "should have insisted upon other language" if he had "any reservations about the scope of the indemnity clause." *Id.* at 1352. The Seventh Circuit squarely faced the public policy concerns which troubled the majority in *Layman*:

> Public policy does not intervene as plaintiffs assert. This is not a loss created by [defendant] that plaintiffs are forced to pay. Rather, the loss (litigation expenses) resulted from a successful defense of a suit brought by plaintiffs."

Id. at 1352.

Another example of the traditional rule is *Tartell v. Chelsea Nat'l. Bank*, 470 F.2d 994 (2d Cir. 1972), in which the Second Circuit essentially adopted the opinion below, *Tartell v. Chelsea Nat'l Bank,* 351 F. Supp. 1071 (S.D.N.Y. 1972), which held that a bank could collect attorneys' fees under a clause which stated: "The undersigned (Tartell) will

pay to the Bank all expenses (including expenses for legal services of every kind) . . . incidental to the enforcement of any of the provisions hereof . . . ." *Id.* at 1079. The opinion adopted by the Second Circuit specifically recognized that "[t]he federal statutes underpinning plaintiff's claims in this case do not specifically provide for counsel fees; indeed, the usual rule is that in the absence of statutory authority or an authorizing contract, federal courts do not award counsel fees." *Id.* The opinion also rejected the argument that the unsuccessful plaintiff should "not be unfairly penalized for asserting claims, as was his right, under the applicable federal statutes," since the "broad language of the demand note in question" was something of which the plaintiff must have been aware. *Id.*

Both *Samuels* and *Tartell* applied standard state law contractual interpretation principles to the indemnity provisions at issue. *Zissu* distinguished *Tartell* on the grounds that the *Tartell* indemnity clause mentioned legal expenses.

Layman conflicts with *Samuels* and *Tartell* and goes beyond *Zissu* because *Layman* required an explicit statement that "if the investor breaches a warranty in suing the sellers, and loses, then the investor must pay the defendants' fees." *Layman*, 994 F.2d at 1352, App. at A-17, A-18. In dissent, Judge Kozinski stated that his colleagues in the majority refused to enforce the contract "under the guise of interpretation" when their true motivation was that they found the Contract unpalatable. *Id.* at 1354, App. at A-24. According to Judge Kozinski, "The clause in question says precisely what the sellers claim: It entitles them to attorney's fees for litigation arising out of misrepresentations by the subscribers as to what they did and did not rely on." *Id.* at 1354-55, App. at A-24.

Layman also conflicts with two recent Ninth Circuit decisions. It conflicts with *Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025 (9th Cir. 1992), because *Atari* was a stock fraud case which enforced an indemnity clause which was less specific than the indemnity clause in *Layman*. In *Atari*, the counterclaim was based upon an indemnity claim which merely said "[Atari] will indemnify all present and former officers and directors of the company to the fullest extent permitted by applicable law with respect to all acts and omissions arising out of such individuals' services as officers, directors or employees of the company. . . ." *Id.* at 1031.

Ironically, in its opinion on the merits in this case, *McGonigle v. Combs*, 968 F.2d 810, 827 (9th Cir.), *cert. dismissed*, 113 S. Ct. 399 (1992), this same panel unanimously affirmed the district court's award of over $200,000 in attorneys' fees to defendant Central Bank under an indemnity clause no more specific than the indemnity clause in the Contract. *Id.* at 827 n.22. The Central Bank counterclaim was based on a promissory note which provided that "The Maker will pay on demand all costs of collection and attorneys' fees incurred or paid by the Holder in enforcing this note on default."

Lower federal court cases applying traditional state law rules to indemnity contracts in stock fraud contexts include *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1572 (M.D. Fla. 1989). In *Barnebey*, the court held an indemnity clause similar to that in the Farm Contract could be enforced because it did not violate public policy. The court denied summary judgment and sent the case to the jury.

B. *Zissu* and *Layman* Create A Federal Rule Of Narrow Construction Against the Sellers of Securities Whenever Stock Fraud Is Alleged.

Zissu v. Bear, Stearns & Co., 805 F.2d 75 (2d Cir. 1986), *Layman*, and their progeny have sought to create a federal rule of narrow construction in interpreting indemnity provisions. These courts have rejected traditional state law interpretation of indemnity agreements and are in the process of "federalizing" a new standard of interpretation. *Zissu* was explicit about departing from established state law:

> although New York courts have held that contractual indemnity provisions for attorneys' fees will be enforced, and broad indemnification provisions like the one here should be read to extend to such fees, a higher level of specificity is required when attorneys' fees are being assessed against a plaintiff suing for securities fraud.

Id. at 79-80 (citations omitted).

Zissu did not specify what it meant by "a higher level of specificity," although it hinted that the indemnity it dealt with should have specifically included the words "attorneys' fees." The *Layman* majority, applying *Zissu*, found an indemnity clause insufficient as a matter of law even though it did specifically include the words "attorneys' fees."

Layman held that even more specificity is required. As Judge Kozinski stated:

> Here we have just such a higher level of specificity [as *Zissu* required]: Every subscriber agreed to indemnify the sellers

> "from and against any losses, claims, damages, liabilities, *[and] expenses (including attorneys' reasonable fees and disbursements)* . . . resulting from the untruth of any of the warranties" (emphasis added). The lack of notice that troubled the Second Circuit in *Zissu* just isn't a problem here.

Layman, 994 F.2d at 1356, App. at A-28 (emphasis added by Judge Kozinski).

II.

The Federal Rule of Narrow Construction Against the Sellers of Securities Conflicts With State Law Enforcing The Plain Meaning Of Indemnity Contracts.

The federal narrow construction rule now emerging conflicts with well settled state law rules of contractual interpretation. The local law of the state which has the most significant relationship to the transaction applies to questions of contractual interpretation absent an effective choice of law by the parties. *Commercial Ins. Co. of Newark, New Jersey v. Pacific-Peru Constr. Corp.*, 558 F.2d 948 (9th Cir. 1977). Cases specifically addressing indemnity clauses have applied the law of the state in which the contract was entered into. *Hill v. Chrysler Corp.*, 526 F.2d 350 (5th Cir. 1976); *see also Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941) (holding that in interpreting a contract, a court should apply the law of the state in which the parties entered into the contract).

The *Samuels*, *Tartell*, *Atari* and *McGonigle* cases enforcing the plain meaning of broadly worded attorneys' fees and indemnity clauses are in the main stream of contractual interpretation. "It is axiomatic that absent a violation of public policy, a statute, or a constitutional

provision, the parties to a private agreement may allocate risks in any manner they so choose." *Reserve Ins. Co. v. Pisciotta*, 30 Cal. 3d 800, 814, 180 Cal. Rptr. 628, 636, 640 P.2d 764 (1982); *Hendrix v. Fireman's Fund Ins. Co.*, 823 S.W.2d 937, 941 (Ky. Ct. App. 1991) ("The parties to a private agreement may allocate risks in any manner they choose, absent a violation of law."); *Perpetual Real Estate Servs., Inc. v. Michaelson Properties, Inc.*, 974 F.2d 545, 550 (4th Cir. 1992) ("Absent some evidence of misrepresentation, 'courts should not rewrite contracts or disturb the allocation of risk the parties have themselves established'.").[13]

"[E]xpress indemnity rests on the contract of the parties; it is the language of contract, rather than the equities of the situation which govern. In an express indemnity agreement, the parties may agree to results which would not occur in absence of an express agreement. . . ." *Smoketree - Lake Murray, Ltd. v. Mills Concrete Constr. Co.*, 234 Cal. App. 3d 1724, 1737, 286 Cal. Rptr. 435, 452 (1991); *United Food & Commercial Workers Union v. Lucky Stores, Inc.*, 806 F.2d 1385, 1386 (9th Cir. 1986) ("Wise or not, a deal is a deal.").

Judge Kozinski, in his dissent in *Layman*, noted that the majority's summary judgment ruling conflicts with the highest court of the state of California: "California law is

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[13] The plain meaning rule is rooted in common sense and judicial restraint. *See* Frederick Schauer, *Statutory Construction and The Coordination Function of Plain Meaning*, 1990 Supreme Court Review 231, 232 (1991) ("[Supreme Court Justices] know that when they ask a law clerk for a tuna fish sandwich and the briefs in *Roe v. Wade*, what they get is a tuna fish sandwich and the briefs in *Roe v. Wade*."); *Pavelic & LeFore v. Marvel Entertainment Group*, 493 U.S. 120, 126 (1989) ("Our task is to apply the text, not to improve on it.").

just the opposite. If the language of a contract is susceptible to two different meanings, each side is entitled to put in evidence supporting its preferred construction. *See, e.g., Pacific Gas & Elec. Co. v. G.W. Thomas Drainage & Rigging Co.*, 69 Cal. 2d 33, 37, 69 Cal. Rptr. 561, 442 P.2d 641 (1968). Even if the language seems susceptible to only one meaning, a party may still put on evidence that a second meaning reflects the parties' actual intent. *Id.* at 39-40." *Layman*, 994 F.2d at 1355, App. at A-25, A-26. California's position on the issue is illustrated by *Finalco, Inc. v. Roosevelt*, 235 Cal. App. 3d 1301, 1306, 3 Cal. Rptr. 2d 865, 867 (1991), which enforced an indemnity clause obligating a buyer of stock "to pay all costs of collection, . . . including . . . attorneys' fees" incurred in successfully defending against federal securities law claims arising out of a private placement.[14]

Similarly, under Kentucky law the right to recover under indemnity contracts is also well recognized. "[Indemnity] contracts are not against public policy and will be enforced if the indemnitee has suffered loss." *United States Fidelity & Guar. Co. v. Napier Elec.*, 571 S.W.2d 644, 646 (Ky. App. 1978).

In *Brownell Combs II v. Zenya Yoshida*, No. 90-131 (E.D. Ky. filed June 4, 1993), the Kentucky district court

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[14] The State Bar of California even uses such agreements in a form book and computer diskette of forms which it makes available to California lawyers. Ellen L. Batzel, California Continuing Education of the Bar, *Advising California Partnerships* § 5.38 at 58-59 (2d ed., Supp. 1993) ("the undersigned [has] relied only on the information contained in the Memorandum. . . . The undersigned agrees to indemnify [the sellers] against any . . . expense . . . arising out of: (i) any inaccuracy in the undersigned's . . . representations and warranties. . . ")

construed the same indemnity contract as the Ninth Circuit did in *Layman*. *Combs* applied Kentucky law because the Contract was entered into in Kentucky. *Combs* noted "Kentucky's well recognized policy of upholding the right of recovery under indemnity contracts. . . ." *Id.* at 7, App. at A-58. The court went on to state that "the *plain language* of the indemnity clause does not limit indemnification to the situation where the registration exemption is lost. . . . " *Id*, App. at A-58. (emphasis added).

This Court has upheld a wide variety of contracts against claims that federal policies counseled against enforcement. *See, e.g., Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220 (1987) (enforcing agreement to arbitrate securities claims despite the historical judicial hostility toward such contracts); *Carnival Cruise Lines, Inc. v. Shute,* 111 S.Ct. 1522 (1991) (enforcing forum selection clause contained in cruise line's passenger's ticket).

The *Layman* and *Zissu* rule of narrow construction, in contrast, is an activist rule creating a federal preemption which ignores the deference our system of federalism gives to the states on issues of contractual interpretation.

III.

The Federal Rule of Narrow Construction Against Sellers of Securities Leads to Unfair, Inconsistent, Anomalous and Extreme Results.

A. Unfair Favoritism of Stock Buyers Over Stock Sellers.

The *Layman* decision tips the scales of contractual interpretation in favor of stock buyers and against stock sellers. Ironically, Rule 10b-5 was promulgated in order to equalize the remedies between defrauded sellers and buyers

of securities. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 736 (1975), stated that "Rule 10b-5 was adopted in order to close 'a loophole in the protections against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.'"

By immunizing stock buyers against liability for their untrue representations, *Layman* and *Zissu* turn Rule 10b-5 on its head.

In this case the *Layman* and *Zissu* rule also upset the delicate bargain struck between the sellers and the plaintiffs who paid only $7.50 per share for their Farm stock and gave written representations and warranties. Only three months later, the sellers sold Farm stock to the public at $12 per share but received no representations and warranties. *McGonigle v. Combs,* 968 F.2d 810, 815 (9th Cir.), *cert. dismissed*, 113 S. Ct. 399 (1992). The private placement buyers' representations, warranties and indemnity promises were clearly worth a portion of the $4.50 per share differential to the sellers. The effect of the *Layman* and *Zissu* line of cases is to nullify a portion of the bargained-for consideration negotiated by sellers in private placements.

B. Inconsistent Results in the Same Case.

Inconsistent results are no better illustrated than by the fact that two different district courts have reached diametrically different results about the same indemnity clause in the same Contract, about attorneys' fees in the same private offering litigation. In *Brownell Combs II v. Zenya Yoshida,* No. 90-131 (E.D. Ky. filed June 4, 1993), the Eastern District of Kentucky construed the same indemnity provision in the same Contract as the instant

case. On summary judgment, *Combs* refused to follow *Layman*'s narrow construction against sellers in interpreting the Contract. Instead, *Combs* held that the Kentucky jury[15] was entitled to decide the plain meaning of the Contract.

Combs rejected both the arguments raised by plaintiffs in *Layman*, namely, that the indemnity should be limited solely to untrue representations that result in loss of the private placement exemption, and that the Securities Act of 1933, § 11, 15 U.S.C. § 77k(e) (1993), provides the sole mechanism for obtaining attorneys' fees in a stock fraud suit. *Combs*, slip op. at 5, App. at A-55, A-56, A-57.

With respect to plaintiffs' arguments as to the Securities Act of 1933, § 11, 15 U.S.C. § 77k(e) (1993), *Combs* refused to read new words into the statute:

> Nowhere in § 77k(e) does the word *only* appear, and this Court will not add the word *only* by judicial fiat. Absent any explicit statutory language or any supportive case law . . . , the Court cannot conclude that

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[15] One of the sellers, Brownell Combs, was denied leave to file his counterclaim in the Northern District of California, so he took his case to Kentucky. By virtue of the fact that Mr. Combs brought his action in Kentucky, he is now going to trial. In their monumental study of this Court's certiorari practices, Samuel Estreicher & John E. Sexton, *A Managerial Theory of the Supreme Court's Responsibilities: An Empirical Study*, 59 N.Y.U. L. Rev. 681, 725 (1984), concluded that "an intolerable conflict occurs when litigants are able to exploit conflicts affirmatively through forum shopping, or when the planning of primary behavior is thwarted by the absence of a nationally binding rule." Private placements offer great opportunity for forum shopping because investors and potential defendants often reside in different states and offerings are permitted to cross state borders. Advance planning becomes pointless when there is an existing conflict between a half-dozen circuit court decisions.

> assessment of costs is only proper upon a finding that the defendant's prior claims lacked merit.

Combs, slip op. at 5, App. at A-55, A-56 (emphasis added).

In rejecting plaintiffs' narrow interpretation of the indemnity clause, *Combs* stated:

> This Court has reviewed the record and the documents under dispute and cannot find as a matter of law that the indemnification clause is limited to situations where Spendthrift looses [sic] its registration exemption.

Combs, slip op. at 6, 7, App. at A-57.

Combs alluded to the uncertainty prevailing in federal courts as to indemnity in stock fraud cases: "other jurisdictions are split as to their conclusions regarding the enforceability of the indemnity clauses, and it cannot be said that any clear majority rule exists . . . ." *Combs*, slip op. at 7, App. at A-57.

C. Anomalous Results.

A federal rule of narrow construction against sellers of securities leads to anomalous results, such as the *Layman* majority terming irrational those who would interpret an indemnity clause according to its plain meaning, a class which includes all the petitioners here, Judge Kozinski, the Eastern District of Kentucky, and the Harvard Law Review.[16] Judge Kozinski noted in his *Layman* dissent that:

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[16] Comment, *Securities Laws - Disclosure Liability - Ninth Circuit Declines to Rule on Whether Investors May Indirectly Waive* (continued...)

"The majority thus holds that a trier of fact would have to be *drunk or crazy to construe the contract to mean what it says.*" *Layman*, 994 F.2d at 1355, App. at A-25 (emphasis added). Judge Kozinski further observed that: "[The majority twists] the law of contract beyond recognition," and "categorically reject[s] the plain language of the contract." *Id.*, App. at A-24, A-26. "I'd just read the disputed language as written." *Id.* at 1356, App. at A-27.

D. Extreme Results.

The increasing hostility with which some federal courts treat indemnity clause in stock fraud cases is reflected in *In re Integrated Resources Real Estate Ltd. Partnership Securities Litigation,* 815 F. Supp. 620 (S.D.N.Y. 1993). There, the district court considered a broad indemnity provision promising that the stock buyers would:

> indemnify the defendants for any and all expense, *including costs and reasonable attorneys' fees* . . . in connection with any of his warranties or his failure to fulfill any of his covenants or agreements under this agreement. . . .

Id. at 657 (emphasis added).

Despite the specific language in this indemnity clause, *Integrated Resources* followed the *Layman* and

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[16](...continued)
Misrepresentation Claims Against Securities Issuers - Layman v. Combs, 981 F.2d 1093 (9th Cir. 1992), 106 Harv. L. Rev. 1697 (1993), criticized *Layman*'s narrow interpretation of the Contract. The author instead endorsed Judge Kozinski's reading of the plain meaning of the Contract, stating: "Judge Kozinski properly rejected the majority's interpretation of Spendthrift's Agreement." *Id.* at 1700.

Zissu line of cases and held that the indemnity clause was not sufficient to put the investors on notice. No hint was found within the four corners of the opinion as to what further notice could ever be deemed sufficient.

Zissu, *Layman* and *Integrated Resources* have required an ever increasing specific threshold for enforcement of indemnity clauses. None of these decisions points out what more is actually required. The only hint given in *Zissu* was that indemnity clauses should clearly refer to "attorneys' fees." However, in *Layman* and *Integrated Resources* even the specific recitation of "attorneys' fees" in the indemnity clause proved insufficient. Stock sellers are left to wonder how much more specific such an indemnity clause must be.

IV.

A Clear Federal Rule Enforcing Indemnity Contracts By Stock Buyers Would Promote The Efficient Operation Of The Nation's Capital Markets.

An unambiguous federal rule enforcing indemnity clauses in stock purchase agreements would have a salutary effect upon the nation's capital markets. Judge Kozinski termed the indemnity clause in question a "perfectly acceptable and useful provision in a private placement agreement." *Layman*, 994 F.2d at 1357, App. at A-30. The majority termed enforcing or agreeing to such a provision as "absurd." *Id.* at 1352, App. at A-18. This dispute is, according to Judge Kozinski, "the meat of the coconut -- the difficult policy question at the heart of this dispute." *Id.* at 1357, App. at A-30.

The enforceability and construction of indemnity clauses have taken on increased significance in this age of

hugely expensive "strike suits."[17] Scholars have addressed the importance and the use of indemnity clauses in private placements,[18] while a recent article in The New York Times[19] discussed proposed legislation aimed at protecting sellers of stock from meritless securities fraud suits.

The popular press has expressed alarm at the burden modern litigation places on parties and society. Walter K. Olson, *The Litigation Explosion - What Happened When America Unleashed the Lawsuit* 337 (1991) ("Full two-way fee-shifting is the single most important and constructive legal reform that ordinary citizens can fight for over the long term. It is memorably simple, and fair, and not easily subverted once put into effect.")

These criticisms and suggested remedies are not limited to the popular press, but have gained support from legal scholars and judges. Robert Bork stated that *The Litigation Explosion* "correctly analyzed the sickness of our litigation system" and provided "prescriptions for at least a partial cure that are worth trying." Robert Bork, *Litigation*

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[17] Janet C. Alexander, *Do The Merits Matter? A Study of Settlements in Securities Class Action*, 43 Stan. L. Rev. 497, 513 (1991) ("[The data] strongly suggest that suits alleging securities violations were filed whenever the stock price declined sufficiently following the IPO to support an award of attorneys' fees that would make it worthwhile to bring a case.").

[18] Henry Klehm III, Comment, *Contractual Shifting of Defense Costs in Private Placement Offering Securities Litigation*, 36 U. Pa. L. Rev. 971 (1988).

[19] Susan Antilla, *A Battle Over Securities Fraud Cases*, The New York Times, July 4, 1993, Section "D" at 14.

Explodes With Well-Told Tale of Unleashing the Lawsuit, Washington Times, April 29, 1991, at F1.

As Judge Kozinski points out in his dissent, we may assume "that our national interest is served when financial markets function efficiently, unbeclouded by the risk of kamikaze litigation." *Layman*, 994 F.2d at 1358, App. at A-33. By limiting the circumstances in which indemnification provisions may be enforceable, the *Zissu* and *Layman* courts necessarily affect the operation of those markets. Like Judge Kozinski, petitioners believe that "a clear statement that [federal courts] *will* enforce a subscriber's warranty he hasn't considered matters outside the offering materials would have an entirely salutary effect [on the efficient operation of the nation's financial markets.]" *Id.* at 1358, App. at A-33, A-34 (emphasis in original).

Enforcing indemnity provisions allows courts to control litigation abuses. As Judge Kozinski documents in his dissent, the litigation the plaintiffs instituted consumed "a staggering quantity of productive resources." *Id.* at 1358, App. at A-32. Millions of dollars were spent defending claims which were judged to be without merit. The amount of judicial resources expended was equally alarming. These costs were directly attributable to the plaintiffs' untrue representations. If the provisions of the Contract -- and contracts like it -- are not given effect, one would expect to see those same litigation techniques employed again by other investors. Shifting the costs where they belong -- to parties who have agreed to accept them -- will enable courts to strike a blow against abusive litigation without engaging in judicial activism.

Moreover, indemnification provisions in subscription agreements enable sellers to limit and control the informa-

tion provided to investors. Documents such as the Farm's PPM are carefully drafted and reviewed for accuracy and legal sufficiency. The purpose of this process is to provide accurate information to prospective investors. This goal is thwarted if investors disregard the offering materials and base their decisions on other purported information -- which may not be subject to the same scrutiny and controls as the written offering materials.

Enforcement of indemnification contracts will have the beneficial effect of allowing sellers and others to rely upon the information provided to them by investors. Put another way:

> The purpose of the contractual indemnification provision is to hold a wealthy and sophisticated investor to her warranties and to insure that she has read and understands, the precise disclosures with which the law requires she be provided. To hold that such a provision is "contrary to the Act" makes disclosure the futile and expensive exercise many fear. After all, who is better situated to understand the mandated disclosure than the knowledgeable and experienced investor?

Henry Klehm III, Comment, *Contractual Shifting of Defense Costs in Private Placement Offering Securities Litigation,* 36 U. Pa. L. Rev. 971, 988 (1988).

CONCLUSION

For these reasons and those stated in Judge Kozinski's dissent, Petitioners urge this Court to grant a writ of certiorari. Doing so will resolve a festering conflict

among the circuits, prevent forum shopping, and inject needed clarity and certainty into federal law.

Dated: August 9, 1993

Respectfully submitted,

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No. _____

In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PROOF OF SERVICE BY MAIL

State of California

ss.

County of Los Angeles

I, the undersigned, say: I am and was at all times herein mentioned, a citizen of the United States and a

resident of the County of Los Angeles, over the age of eighteen (18) years and not a party to the within action or proceeding; that my business address is 9105 Sunset Boulevard, West Hollywood, California 90069; that on August 9, 1993, I served the within *Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit* in said action or proceeding on all parties required to be served by depositing true copies thereof, enclosed in sealed envelopes with first-class postage thereon fully prepaid, in the United States mail at Los Angeles, California, addressed as follows:

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One First Street, N.E.
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I declare under penalty of perjury that the foregoing is true and correct. Executed on August 9, 1993, at Los Angeles, California.

Betty J. Malloy
(Original Signed)

93-214

No. _____

Supreme Court, U.S.
FILED
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In the Supreme Court of the United States

October Term, 1993

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RESPONDENTS.

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No. _____

In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

APPENDICES TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

APPENDIX A

George E. LAYMAN, et al., Plaintiffs,

v.

Brownell COMBS, II, et al., Defendants.

Frank L. BRYANT, Counter-claimant-Appellant,

v.

George E. LAYMAN and George E. Layman, Jr., d/b/a Forest Acres Partnership, a Washington general partnership; Barry K. Schwartz and Calvin Klein d/b/a Barry K. Schwartz Partnership; Earl H. Schultz; and Kenneth Franzhein, II, Counter-claim-defendants-Appellees.

George E. LAYMAN, et al., Plaintiffs,

v.

Brownell COMBS, II, et al., Defendants.

BATEMAN EICHLER, HILL RICHARDS, INC., and Robert J. McGuiness, Counter-claimants-appellants

v.

E. LAYMAN and George E. Layman, Jr., d/b/a Forest Acres Partnership, a George Washington general partnership; Barry K. Schwartz and Calvin Klein d/b/a Barry K. Schwartz Partnership; Earl H. Schultz; and Kenneth Franzhein, II, Counter-claim-defendants-Appellees.

George E. LAYMAN, et al., Plaintiffs,

v.

Brownell COMBS, II, et al., Defendants.

Charles R. HEMBREE; Kincaid, Wilson, Schaeffer and Hembree, P.S.C., Counter-claimants-Appellants,

v.

George E. LAYMAN and George E. Layman, Jr., d/b/a Forest Acres Partnership, a Washington general partnership; Barry K. Schwartz and Calvin Klein d/b/a Barry K. Schwartz Partnership; Earl H. Schultz; and Kenneth Franzhein, II, Counter-claim-defendants-Appellees.

H. James GRIGGS, Plaintiff,

v.

Brownell COMBS, II, et al., Defendants.

BATEMAN EICHLER, HILL RICHARDS, INC., and Robert J. McGuiness, Counter-claimants-Appellants,

v.

H. James GRIGGS, Counter-claim-defendant-Appellee.

H. James GRIGGS, Plaintiff,

v.

Brownell COMBS, II, et al., Defendants.

Charles R. HEMBREE; Kincaid, Wilson, Schaeffer and Hembree, P.S.C., Counter-claimants-Appellants,

v.

H. James GRIGGS, Counter-claim-defendant-Appellee.

Zenya YOSHIDA d/b/a Shadai Farm, Plaintiff,

v.

Brownell COMBS, II, et al., Defendants.

Frank L. BRYANT, Defendant-counter-claimant-Appellant,

v.

YOSHIDA d/b/a Shadai Farm, Counter-claim-defendant-Appellee.

Zenya YOSHIDA d/b/a Shadai Farm, Plaintiff,

v.

Brownell COMBS, II, et al., Defendants.
BATEMAN EICHLER, HILL RICHARDS, INC.; Robert J. McGuiness, Counter-claimants-Appellants,

v.

Zenya YOSHIDA d/b/a Shadai Farm, Counter-claim-defendant-Appellee.
Zenya YOSHIDA d/b/a Shadai Farm, Plaintiff,

v.

Brownell COMBS, II, et al., Defendants.
Charles R. HEMBREE; Kincaid, Wilson, Schaeffer and Hembree, P.S.C., Counter-claimants-Appellants,

v.

Zenya YOSHIDA d/b/a Shadai Farm, Counter-claim-defendant-Appellee.
Robert D. STRATMORE, Plaintiff,

v.

Leslie COMBS, II, et al., Defendants.
Frank L. BRYANT, Counter-claimant-Appellant,

v.

Robert D. STRATMORE, Counter-claim-defendant-Appellee.
Robert D. STRATMORE, Plaintiff,

v.

Leslie COMBS, II, et al., Defendants.
BATEMAN EICHLER, HILL RICHARDS, INC., and Robert J. McGuiness, Counter-claimants-Appellants,

v.

Robert D. STRATMORE, Counter-claim-defendant-Appellee.

Robert D. STRATMORE, Plaintiff,

v.

COMBS, II, et al., Defendants. Lesli
Charles R. HEMBREE, and Kincaid, Wilson, Schaeffer
and Hembree P.S.C., Counter-
claimant-Appellants,

v.

Robert D. STRATMORE,
Counter-claim-defendant-Appellee.
Richard D. SCHULTZ, Plaintiff,

v.

BATEMAN EICHLER, HILL RICHARDS, INC., et al.,
Defendants.
Frank L. BRYANT, Counter-claimant-Appellant,

v.

Richard L. SCHULTZ,
Counter-claim-defendant-Appellee.
BATEMAN EICHLER, HILL RICHARDS, INC.; Robert
J. McGuiness, Counter-claimant-
Appellant,

v.

Richard L. SCHULTZ,
Counter-claim-defendant-Appellee.
Richard D. SCHULTZ, Plaintiff,

v.

BATEMAN EICHLER, HILL RICHARDS, INC., et al.,
Defendants.
Charles R. HEMBREE; Kincaid, Wilson, Schaeffer &
Hembree, P.S.C., Counter-
claimants-Appellants,

v.

Richard L. SCHULTZ,
Counter-claim-defendant-Appellee.

Blas R. CASARES,
Plaintiff-counter-claim-defendant-Appellee,
v.
SPENDTHRIFT FARM, INC., Defendant,
and
Frank L. Bryant, Defendant-counter-claimant-Appellant.
Blas R. CASARES, Plaintiff,
v.
SPENDTHRIFT FARM, INC., et al., Defendants.
BATEMAN EICHLER, HILL RICHARDS, INC., a
Delaware corporation; Robert J.
McGuiness, Counter-claimants-Appellants,
v.
Blas R. CASARES, Counter-claim-defendant-Appellee.
Blas R. CASARES, Plaintiff,
v.
SPENDTHRIFT FARM, INC., et al., Defendants.
Charles R. HEMBREE; Kincaid, Wilson, Schaeffer &
Hembree, P.S.C., a Kentucky
professional corporation, Counter-claimants-Appellants,
v.
Blas R. CASARES, Counter-claim-defendant-Appellee.
John F. McGONIGLE; Virginia M. McGonigle, Plaintiffs,

v.
Leslie COMBS, II, et al., Defendants.
Frank L. BRYANT,
Defendant-counter-claimant-Appellant,
v.
John F. McGONIGLE; Virginia M. McGonigle,
Counter-claim-defendants-Appellees.
John F. McGONIGLE; Virginia M. McGonigle, Plaintiffs,
v.

Leslie COMBS, II, et al., Defendants.
BATEMAN EICHLER, HILL RICHARDS, INC.; Robert J. McGuiness, Defendants-counter-claimants-Appellants,
v.
John F. McGONIGLE; Virginia M. McGonigle, Counter-claim-defendants-Appellees.
John F. McGONIGLE; Virginia M. McGonigle, Plaintiffs,
v.
Leslie COMBS, II, et al., Defendants.
Charles R. HEMBREE; Kincaid, Wilson, Schaeffer and Hembree, P.S.C., Defendants-counter-claimants-Appellants,
v.
John F. McGONIGLE; Virginia M. McGonigle, Counter-claim-defendants-Appellees.
Robert D. STRATMORE, Plaintiff,
v.
Leslie COMBS, II, et al., Defendants.
Garth GUY, Defendant-counter-claimant-Appellant,
v.
Robert D. STRATMORE, Counter-claim-defendant-Appellee.
Leslie COMBS, II, et al., Defendants,
and
Garth Guy, Defendant-counter-claimant-Appellant,
v.
George E. LAYMAN and George E. Layman, Jr., d/b/a Forest Acres Partnership, a Washington general partnership; Barry K. Schwartz and Calvin Klein d/b/a Barry K. Schwartz Partnership, a New York general partnership; Earl

H. Schultz; and Kenneth Franzhein, II,
Counterclaim-defendants-Appellees.
Zenya YOSHIDA d/b/a Shadai Farm, Plaintiff,
v.
Brownell COMBS, II, et al., Defendants.
Garth GUY, Defendant-counter-claimant-Appellant,
v.
Zenya YOSHIDA d/b/a Shadai Farm,
Counter-claim-defendant-Appellee.
John F. McGONIGLE; Virginia M. McGonigle, Plaintiffs,
v.
Brownell COMBS, II, et al., Defendants.
Garth GUY, Defendant-counter-claimant-Appellants,
v.
John F. McGONIGLE; Virginia M. McGonigle,
Counter-claim-defendants-Appellees.
Blas R. CASARES, Plaintiff,
v.
Brownell COMBS, II, et al., Defendants.
Garth GUY, Defendant-counter-claimant-Appellant,
v.
Blas R. CASARES, Counter-claim-defendant-Appellee.
Richard D. SCHULTZ, Plaintiff,
v.
Leslie COMBS, II, et al., Defendants.
Garth GUY, Defendant-counter-claimant-Appellant,
v.
Richard L. SCHULTZ,
Counter-claim-defendant-Appellee.
HAMILTON PARTNERS, et al., Plaintiffs,
v.
Brownell COMBS, II, et al., Defendants.
Garth GUY, Defendant-counter-claimant-Appellant,

v.

HAMILTON PARTNERS, an Ohio general partnership; Frank E. Fowler; James P. Coleman; Mercer Reynolds III; William O. Dewitt, Jr.; Northwood Ventures; Peter G. Schiff; Gateway Investment Partnership; Calvin Ingram, Counter-claim-defendants-Appellees.

H. James GRIGGS, Plaintiff,

v.

Leslie COMBS, II, et al., Defendants.

Frank L. BRYANT, Defendant-counter-claimant-Appellant,

v.

H. James GRIGGS, Counter-claim-defendant-Appellee.

H. James GRIGGS, Plaintiff,

v.

Brownell COMBS, II, et al., Defendants.

Garth GUY, Defendant-counter-claimant-Appellant,

v.

H. James GRIGGS, Counter-claim-defendant-Appellee.

Nos. 89-16621, 16622, 16623, 16641, 16642, 16644, 16646, 16647, 16648, 16650, 16651, 16657, 16658, 16660, 16665, 16666, 16667, 16670, 16674, 16675, 16680, 16684, 16686, 16688, 16690, 16692, 16696, 16698, 16726.

United States Court of Appeals,

Ninth Circuit.

Argued and Submitted Sept. 13, 1991.

Decided Dec. 17, 1992.

Appeal from the United States District Court for the Northern District of California.

Before CANBY and KOZINSKI, Circuit Judges, and CARROLL,* District Judge.

CANBY, Circuit Judge:

Certain defendants in *McGonigle v. Combs*, 968 F.2d 810 (9th Cir.1992), appeal the district court's summary judgment rejecting their counterclaim for attorneys' fees.[1] The counterclaim alleged that the defendants were entitled to recover their fees because the plaintiffs' breaches of certain warranties triggered an indemnification clause to which plaintiffs had agreed. In addition, defendant Frank Bryant appeals the district court's denial of his requests for attorneys' fees under Section 11(e) of the Securities Act of 1933, 15 U.S.C. § 77k(e) (1988), Rule 11 of the *Federal Rules of Civil Procedure*, and Rule 37(c) of the *Federal Rules of Civil Procedure*. We reverse and remand the district court's denial of Bryant's request for attorneys' fees under Section 11(e), and we affirm the district court's rejection of the remaining claims.

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* The Honorable Earl H. Carroll, United States District Judge for the District of Arizona, sitting by designation.

[1] Defendant Frank Bryant also claims certain other damages arising from the plaintiffs' breach of warranties, which he asserts are covered by the indemnity clause.

THE DEFENDANTS' CONTENTION THAT THE SUBSCRIPTION AGREEMENT ENTITLES THEM TO ATTORNEYS' FEES

Factual Background

This counterclaim is one of many components of a complex securities litigation involving Spendthrift Farms, a thoroughbred horse breeder. Plaintiffs were investors in a private placement of Spendthrift stock; when the thoroughbred market declined, they sued a string of defendants, alleging a variety of fraudulent acts and omissions. The district court granted summary judgment for the defendants on most of the claims and directed a verdict on several others; the jury returned a complete defense verdict on the remaining claims. The merits of the lawsuit are considered in *McGonigle v. Combs*, and other related issues are treated in *Schultz v. Hembree,* 975 F.2d 572 (9th Cir.1992).

After the defendants prevailed on all counts, several of them--Frank Bryant; Robert McGuiness and his employer, the investment banker Bateman Eichler, Hill Richards, Incorporated; and Charles Hembree and his law firm, Kincaid Wilson, Schaeffer & Hembree, P.S.C.--pressed this counterclaim seeking reimbursement of the attorneys' fees they incurred. The basis of these defendants' counterclaim is a subscription agreement attached as an appendix to the Private Placement Memorandum ("PPM") for the private offering of shares in Spendthrift. Each of the plaintiffs signed the subscription agreement in the course of his or her purchase of shares in Spendthrift.[2] The subscription

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[2] Investor Blas Casares contends on appeal that he did not sign the agreement until after the stock was issued in his name, and, (continued...)

agreement contains, inter alia, twenty-two "representations and warranties" that occupy more than three pages of single-spaced type. These representations include, for example, that "it has been called to [the investor's] attention both in the [Private Placement] Memorandum and by those individuals with whom he has dealt in connection with his investment in the shares that his investment in the Company involves a substantial degree of financial risk," and that "[the investor] has received no representations or warranties from the Sellers or any of the Sellers [sic] officers, directors, employees or agents other than those contained in the [Private Placement] Memorandum." Each investor further warrants, among other things: that he has a net worth of at least $5,000,000 and is knowledgeable in financial matters; that he has read the PPM; that he understands that the shares are subject to restrictions on transfer; that he is not purchasing the shares with a view to resale; and that he will not sell or transfer his shares without providing the sellers with an unqualified opinion of counsel that the sale or transfer "complies with the 1933 Act and any applicable federal and state securities laws and regulations."

The subscription agreement also contains an indemnification clause, which states as follows:

5. *Indemnification*. The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber hereby agrees that such representations and warranties shall

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[2](...continued)
therefore, that he is not bound by the indemnity provision. In light of our affirmance of the district court's ruling, we do not reach the question whether Casares was bound by that provision.

survive his purchase thereof. The Subscriber hereby agrees to indemnify and hold harmless the Company, the Sellers and agents of each of them from and against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements), judgements and amounts paid in settlement resulting from the untruth of any of the warranties and representations contained herein, or the breach by the Subscriber of any of the covenants made by him herein. Notwithstanding the foregoing, however, no representation, warranty, acknowledgement or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

The defendants argue that, in pursuing this litigation, the plaintiffs breached their warranties in the Subscription Agreement by averring, for example, that they relied on representations made by the defendants outside of the PPM and that they were misled into believing that their investment in Spendthrift entailed little risk. The defendants contend that, in light of those breaches, the indemnification clause obligates the plaintiffs to pay the defendants' attorneys' fees.

Discussion

The material facts are not in dispute; the plaintiffs acknowledged for purposes of summary judgment that they breached certain provisions of the security agreement in bringing their lawsuit. The plaintiffs contend, however, that they are not obligated to reimburse the defendants for their attorneys' fees because the indemnification clause is limited to liability arising from breaches that cause the sellers to lose their private placement registration exemption under SEC Rule 506, 17 C.F.R. § 230.506 (1992), or comparable

exemptions under state blue sky laws. The sellers have not lost any such exemption. Thus the only question before us is a straightforward one: Does the indemnification clause obligate the plaintiffs, who are assumed to have breached their warranties, to pay the attorneys' fees of the defendants that were incurred in defending the plaintiffs' unsuccessful claims?[3]

The first page of the PPM states that

> [t]he Sellers will impose certain standards which prospective investors must meet in order to be eligible to purchase the shares. These suitability standards are designed to assure compliance with Section 4(1) of the Securities Act of 1933 and Regulation D promulgated by the Securities and Exchange Commission thereunder and with the Blue Sky Laws of the states in which this offering will be made.

This concern that the offering meet all the requirements for a registration exemption is reflected in the representations and warranties of the subscription agreement, which--as both the plaintiffs and the defendants acknowledge--contain the "suitability standards" mentioned in the sentence above. As a result, many of the representa-

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[3] Because none of the parties suggests that we apply any particular state's substantive law, we apply the law of the forum state, California. Under California law, a court interpreting a contract should "look for expressed intent, under an objective standard." 1 B.E. Witkin, *Summary of California Law Contracts* 684 (9th ed. 1987); accord *Stevenson v. Oceanic Bank*, 223 Cal.App.3d 306, 272 Cal.Rptr. 757, 763 (Cal.Ct.App.1990).

tions in the subscription agreement track, verbatim, the language of Regulation D.

More important for our purposes, the opening sentence of the indemnification clause focuses on the suitability standards: "The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber hereby agrees that such representations and warranties shall survive his purchases thereof." This language indicates that the focus of the indemnification was on ensuring, first, that the suitability standards were met, so that the sellers could retain their private placement registration, and, second, that, if the registration were lost and damages resulted, the investor who caused the loss would be liable.

The defendants would have us focus on the second sentence of the indemnification clause, which states that

> [t]he Subscriber hereby agrees to indemnify and hold harmless the Company, the Sellers and agents of each of them from and against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements), judgements and amounts paid in settlement resulting from the untruth of any of the warranties and representations contained herein, or the breach by the Subscriber of any of the covenants made by him herein.

The defendants point to the broad language of this sentence in support of their contention that the indemnification is not limited to a loss of the registration exemption, but rather applies to all losses that result from a breach

of a representation or warranty--even losses arising from this suit brought by the indemnitors. It is true that this sentence, viewed in isolation, could be read so broadly. But this sentence does not appear in isolation. It immediately follows a sentence focusing on the suitability standards for a private placement exemption. The section of the document in which it appears focuses primarily on the suitability standards. The placement of the indemnification (i.e., immediately after the section on the suitability standards) gives no intimation of a broader purpose than to indemnify for liability arising from loss of the private placement exemption. Moreover, the first page of the PPM sets the stage by focusing on suitability standards. In light of this context, we conclude that the unambiguous[4] expressed intent of the clause is that any investor whose breach of a representation causes the sellers to lose their private placement exemption is obligated to reimburse the sellers for their losses. In our view, a reasonable investor who read the PPM and the subscription agreement would so interpret the indemnification clause.

This analysis comports with that of the leading case on the application of indemnification clauses, *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75 (2d Cir.1986). *Zissu*, like our case, involved a plaintiff who brought suit under the securities laws, alleging, among other things, that he had relied on certain oral misrepresentations. *Id.* at 76. As was

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[4] The defendants contend that, at most, the clause is ambiguous because the literal language of the indemnity clause can be read to cover this case. They assert that summary judgment is therefore improper. We find no ambiguity, but in any event we conclude, for reasons set forth in the text of our opinion, that no rational trier of fact could attribute to the clause the meaning urged by the defendants.

the case here, *Zissu* had warranted in his subscription agreement that no oral representations had been made to him. *Id.* at 77. Furthermore, the indemnification clause in *Zissu* was similar to the one in this case, in that *Zissu* agreed to indemnify and hold harmless the sellers "against any and all loss, damage or liability due to or arising out of a breach of any representation or warranty" that he had made in the subscription agreement. *Id.* The clause in *Zissu* did not mention attorneys' fees, and the court underscored that omission, but the court's reasoning went beyond the mere presence or absence of the words "attorneys' fees":

> The "any and all damages" clause of the Subscription Agreement in this case did not meet the requisite level of specificity necessary to hold *Zissu* liable to reimburse Encore and Bear Stearns for defense costs in their successful defense against *Zissu*'s securities claims. The clause *Zissu* signed did not put him on notice that he would be responsible for defendants' legal fees incurred in the security fraud suit. In fact, no mention of attorney's fees was made in the indemnification clause. Instead, the warranties in question were necessary to exempt the limited partnership from the requirements of the 1933 Act and are so understood by investors. That being the case, the parties had little reason to expect that such warranties might also be the basis for the counterclaim made in the present case. Thus, although New York courts have held that contractual indemnity provisions for attorneys' fees will be enforced, and broad indemnification provi-

> sions like the one here should be read to extend to such fees, a higher level of specificity is required when attorneys' fees are being assessed against a plaintiff suing for securities fraud.

Id. at 79-80 (citations omitted).

Zissu thus focused on both the absence of any reference to attorneys' fees and the failure of the indemnification clause to put Zissu on notice that the clause was not limited to reimbursement for the loss of the registration exemption. The defendants suggest that the subscription agreement's reference to attorneys' fees renders Zissu inapplicable, but we disagree. Our reading of Zissu is that a reference to attorneys' fees is necessary but not sufficient; the crucial element of an indemnification is that it put potential investors on notice that the indemnification is not limited, and instead applies to fees and damages incurred in defending a claim brought by the subscribing indemnitor herself. The placement of the indemnifying language, as well as the language itself, must reveal its scope.

A person who contracts to pay an opponent's attorneys' fees if she sues unsuccessfully is agreeing to a departure from the standard American rule that a party prevailing in a lawsuit is not entitled to recover fees from the loser. See *Alyeska Pipeline Service Co. v. Wilderness Society,* 421 U.S. 240, 247, 95 S.Ct. 1612, 1616, 44 L.Ed.2d 141 (1975). It is not too much to ask that a clause effectuating such a deviation from the norm be explicit. The indemnification clause here is worded most peculiarly if its purpose was to shift fees in a 10b-5 case brought by the subscribing investor. The clause nowhere states that, if the investor breaches a warranty in suing the sellers, and loses,

then the investor must pay the defendants' fees. Instead, it promises that the investor will indemnify the sellers from any losses, including attorneys' fees, arising from untruth of any of the warranties signed by the investor--warranties with the stated purpose of preserving the private placement exemption.

The defendants' position is that the expressed intent of the parties, as literally set forth in the indemnification clause, was to force the investors to reimburse the sellers for *all* costs and liability resulting from *any* breach of the representations and warranties. The language thus encompasses this case, they argue. But if the indemnity clause is so interpreted to apply to the plaintiffs' lawsuit for oral misrepresentations, its literal terms would require the plaintiffs to pay the defendants' judgment and attorneys' fees even if plaintiffs prevailed! In our view, the absurdity of such a result--an investor would have a meaningless right to sue, because she would have to pay the judgment and fees of the losing sellers--undermines the reasonableness of the defendants' interpretation of the indemnification.

The defendants respond by pointing out that Section 29 of the Securities Act of 1934, 15 U.S.C. § 78cc (1988) (and its counterpart in the 1933 Act, Section 14, 15 U.S.C. § 77n (1988)) would prohibit a culpable defendant from recovering his losses from the indemnitor plaintiff, thereby eliminating the danger of a successful investor having to reimburse herself. This argument misses the point. We do not suggest that courts would, in fact, require a successful investor litigant to pay her own recovery. The point is simply that, read as the defendants urge, the clause would seem to require that absurd result. That fact suggests to us that the indemnification clause cannot be given the broad

reading that the defendants urge. It further suggests that a reasonable investor would not so interpret the language in agreeing to the clause.[5]

In light of these considerations, we conclude that the indemnification required by the clause in this case does not extend to fees or damages incurred in defending claims brought by the subscribing indemnitor. We therefore affirm the district court's refusal to award attorneys' fees under this clause.

BRYANT'S CHALLENGE TO THE DISTRICT COURT'S REFUSAL TO AWARD FEES UNDER SECTION 11(e) OF THE SECURITIES ACT OF 1933 AND RULES 11 AND 37(c) OF THE *FEDERAL RULES OF CIVIL PROCEDURE*

In addition to joining the main counterclaim, defendant Frank Bryant brought a counterclaim for his attorneys' fees based on Section 11(e) of the Securities Act of 1933, 15 U.S.C. § 77k(e), Rule 11 of the *Federal Rules*

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[5] *Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025, 1031 (9th Cir.1992) (amended opinion), is clearly distinguishable. There the clause in question indemnified "all present and former officers and directors of the Company to the fullest extent permitted by applicable law with respect to all acts and omissions arising out of such individuals' services as officers, directors or employees of the Company or any of its subsidiaries." Nothing in the context narrowed the immense sweep of the indemnifying language. The clause was accordingly held to cover losses caused by an action brought by the indemnitor. In our case, as we explain in the text, the context discloses a narrower purpose.

of Civil Procedure, and Rule 37(c) of the *Federal Rules of Civil Procedure*.[6]

I.

Bryant's Request for Attorneys' Fees Under Section 11(e)

Section 11(e) of the Securities Act of 1933 allows the district court to award attorneys' fees if it "believes the suit or the defense to have been without merit." 15 U.S.C. § 77k(e). "The 'without merit' standard ... encompasses claims and defenses that ... *border on the frivolous.*" *Western Federal Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir.1984) (emphasis added). In its ruling on the defendants' requests for attorneys' fees, the district court stated that, "with respect to some of the claims against Mr. Bryant, McGuiness, [and] Central Bank, that they were--bordered on frivolous." The district court did not award Bryant attorneys' fees under Section 11(e), however, stating that "[w]ith respect to Section 11(e), the standard announced by the 9th Circuit is ... frivolous and brought in

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[6] "We review the district court's rulings on Rule 11 issues under an 'abuse of discretion' standard." *Townsend v. Holman Consulting Corp.*, 929 F.2d 1358, 1365-66 (9th Cir.1990) (en banc). In addition, we review a district court's decision whether or not to award attorneys' fees for abuse of discretion. *Lange v. Penn Mutual Life Insurance Co.* 843 F.2d 1175, 1184 (9th Cir.1988); *Falstaff Brewing Corp. v. Miller Brewing Co.*, 702 F.2d 770, 784 (9th Cir.1983). "However, a district court abuses its discretion if it rests its conclusion on an erroneous legal premise, and questions of law are reviewed de novo." *FSLIC v. Sahni*, 868 F.2d 1096, 1097 (9th Cir.1989); see also *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 405, 110 S.Ct. 2447, 2460, 110 L.Ed.2d 359 (1990); *Cunningham v. County of Los Angeles*, 879 F.2d 481, 487 (9th Cir.1988), *cert. denied*, 493 U.S. 1035, 110 S.Ct. 757, 107 L.Ed.2d 773 (1990).

bad faith.... I didn't think that these claims fall within that category." As Bryant correctly points out, the district court applied an incorrect legal standard to his request for attorneys' fees; the court apparently believed that it had the discretion to award fees only if the claims against Bryant were frivolous, when in fact it could award fees for those that merely bordered on the frivolous. In light of this error, we remand for a determination of *which* claims bordered on the frivolous, and we direct the district court to consider awarding Bryant the attorneys' fees he incurred in defending against those claims.[7]

II.

Bryant's Request for Attorneys' Fees Under Rule 11

Bryant suggests that the district court applied an erroneous legal standard in rejecting his request for attorneys' fees under Rule 11 of the *Federal Rules of Civil Procedure*. He states that the district court applied the standard articulated in the panel decision of *Townsend v. Holman Consulting Corp.*, 881 F.2d 788, 795 (9th Cir.1989) (Rule 11 sanctions appropriate only when all claims against all parties are frivolous), and that the district court's alleged reliance on *Townsend* constituted reversible error in light of the en banc court's rejection of the panel's opinion. *Townsend v. Holman Consulting Corp.*, 929 F.2d 1358 (9th Cir.1990) (en banc) (frivolous claims can be sanctioned

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[7] Bryant also challenges the district court's finding that the plaintiffs' claims against him were not frivolous. Bryant does not point to any error of law but rather disputes the district court's conclusion that, though some claims bordered on the frivolous, none of them were frivolous. We conclude that the district court did not abuse its discretion in so finding.

even if pleading contains non-frivolous claims). The problem with Bryant's argument is that we have no reason to believe that the district court relied on the *Townsend* panel decision. The district court, in rejecting Bryant's Rule 11 request for fees, correctly outlined the standard for awarding fees under Rule 11 (omitting any reference to a requirement that all claims must be frivolous) and then stated that "I don't think that any of the claims made here rise to that level." The court's use of "any" indicates that it did not apply the *Townsend* panel's ruling, and that it concluded that *each* of the claims was neither frivolous nor brought for an improper purpose. The court did not abuse its discretion in so concluding. We therefore reject Bryant's challenge to the district court's refusal to award fees under Rule 11.

III.

Bryant's Request for Attorneys' Fees Under Rule 37(c)

Bryant asserts that the district court applied an incorrect legal standard in refusing to award him fees under Rule 37(c) of the *Federal Rules of Civil Procedure*; he suggests that the district court followed the plaintiffs' erroneous contention that they could not be penalized for their refusal to admit ultimate issues of fact. Bryant misreads the district court's ruling. The district court did not indicate that it adopted the plaintiffs' position, nor did it appear to follow an incorrect legal standard. We find no abuse of discretion in the court's ruling. We therefore reject Bryant's contention that the district court erred in refusing to award attorneys' fees under Rule 37(c).

CONCLUSION

We affirm the district court's refusal to grant attorneys' fees under the indemnification clause of the subscription agreement. We also affirm the district court's denial of Bryant's request for attorneys' fees under Rules 11 and 37(c) of the *Federal Rules of Civil Procedure*. We remand to the district court Bryant's request for attorneys' fees under Section 11(e) of the Securities Act of 1933, so that the court can apply the proper standard.

All parties except defendant-appellant Bryant are to bear their own costs on this appeal. Bryant is entitled to recover his costs from plaintiffs.

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

KOZINSKI, Circuit Judge, dissenting for the most part: The right to make contracts is more than just a socially useful convention; it's an important aspect of personal autonomy. By contract, we can order some of the most important aspects of our existence: housing, health care, education, the pursuit of a profession or vocation, sometimes even marriage. Having the power to bind ourselves in exchange for similar concessions from others gives us a significant measure of control over our lives.

Signing a contract does not, of course, guarantee we will be better off. A system of mutual, free exchange gives us only the opportunity to better ourselves; business acumen, diligence and luck will affect the final tally. The right to contract therefore means the right to take chances, to play hunches, to make mistakes; it means having to live by our decisions, no matter how they turn out: "Wise or not, a deal is a deal." *United Food & Commercial Workers*

Union v. Lucky Stores, Inc., 806 F.2d 1385, 1386 (9th Cir.1986).

While my colleagues don't quarrel with these principles, they do much to undermine them. Confronted with a contract clause they find unpalatable, they refuse to enforce it under the guise of interpretation. But the reasons they offer are not merely unpersuasive; they're transparent. The clause in question says precisely what the sellers claim: It entitles them to attorney's fees for litigation arising out of misrepresentations by the subscribers as to what they did and did not rely on. Reasonable minds can differ as to whether such a clause violates public policy; I believe it does not, but the contrary view is certainly defensible. See pp. 1357-58 *infra*. Less defensible is ducking the issue by twisting the law of contract beyond recognition. Because I cannot agree with the majority's result, and because I see nothing but mischief growing from the way it gets there, I dissent from all but minor portions of the opinion.

A. We must decide whether the following language in the subscription agreement means what it says:

> The Subscriber hereby agrees to indemnify ... the Sellers ... against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements) ... resulting from the untruth of any of the warranties and representations contained herein, or the breach by the Subscriber of any of the covenants made by him herein.

The majority concedes that "viewed in isolation" this provision could expose the subscribers to liability for the sellers' attorney's fees. Maj. op. at 1351. It's hard to reach any other conclusion:

(1) The subscribers made several warranties, among them that they wouldn't rely on any oral representations in entering the agreement.

(2) They then brought this lawsuit claiming that they in fact *did* rely on oral representations.

(3) The sellers were required to defend the lawsuit at considerable expense because the subscribers lied when they warranted they wouldn't rely on oral representations.

(4) The indemnity clause holds sellers harmless for losses "including attorney's reasonable fees and disbursements ... resulting from the untruth of any of the warranties."

(5) The sellers' expenses (consisting largely of attorney's fees) seem to be exactly what the quoted language covers.

Q.E.D.

Recognizing that the quoted language "could be read so broadly," *id.*, the majority nonetheless concludes that it unambiguously provides the contrary. Indeed, "no rational trier of fact could attribute to the clause the [contrary] meaning urged by the defendants." *Id.* at n. 3. The majority thus holds that a trier of fact would have to be drunk or crazy to construe the contract to mean what it says.

California law is just the opposite. If the language of a contract is susceptible to two different meanings, each side is entitled to put on evidence supporting its preferred

construction. *See, e.g., Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.,* 69 Cal.2d 33, 37, 69 Cal.Rptr. 561, 442 P.2d 641 (1968). Even if the language seems susceptible to only one meaning, a party may still put on evidence that a second meaning reflects the parties' actual intent. *Id.* at 39-40, 69 Cal.Rptr. 561, 442 P.2d 641; see also *Brinderson-Newberg Joint Venture v. Pacific Erectors, Inc.,* 971 F.2d 272, 276-77 (9th Cir.1992) (following *Pacific Gas*). I don't understand how we can deny the sellers a trial to prove that the parties in fact intended that the clause "be read so broadly." Maj. op. at 1351.

B. But why does the majority so categorically reject the plain language of the contract? The indemnification clause follows language, the majority explains, which suggests the warranties were made to ensure compliance with the private placement exemption to the federal securities laws. Maj. op. at 1351. For example, each subscriber agreed not to transfer his shares, as required by Rule 506, the exemption relied on here. See 17 C.F.R. §§ 230.506, 230.502(d). Assuring compliance with the securities laws was no doubt the reason for some of the warranties.

Many other warranties do not track the rule, however. Investors in private placements need only be worth $1 million, whereas each subscriber here warranted he had a net worth of at least $5 million. *Id.* § 230.501(a)(5). The subscribers also said they understood the financial statements were unaudited, even though the SEC rules don't require audited statements for Rule 506 offerings, nor any such warranties by subscribers. *Id.* § 230.502(b). Similarly, each investor warranted he had read the offering memorandum, and that the books and accounts of the company were available to him; the regulations state that "[t]he issuer is

not required to furnish [such information] to any accredited investor," *id.* § 230.502(b)(1), which all of these subscribers were. Clearly the sellers sought and obtained warranties beyond those required by the securities laws.

Most telling is the warranty at issue here--that the subscribers weren't relying on representations made outside the offering materials. One searches in vain for this requirement in Rule 506 or anywhere else in the securities laws. How does this dovetail with the majority's conclusion that the warranties served no purpose other than to protect the private placement exemption? What becomes of this warranty under the majority's approach? Are we free to interpret the contract--and declare that no rational trier of fact could do otherwise--so as to render this warranty a nullity?

Left to my own devices, I'd just read the disputed language as written. But if we're going to triangulate the meaning of the indemnity clause by reference to neighboring clauses, surely we must look at all such clauses. The majority does the sellers an injustice by failing to even acknowledge these other provisions.

C. The majority also maintains the indemnity provision wasn't specific enough to put the subscribers on notice. See Maj. op. at 1351-52. It relies on *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75, 79-80 (2nd Cir.1986), for the proposition that the subscribers weren't fairly apprised they could be liable for attorney's fees if their securities suit was unsuccessful. But the indemnity clause at issue in *Zissu* only provided for indemnity "against *any and all loss*, damage or liability due to or *arising out of a breach* of any representation or warranty." *Id.* at 77 (emphasis supplied by *Zissu*). Accordingly, *Zissu* refused to enforce the agreement

because "no mention of attorneys' fees was made in the indemnification clause." *Id.* at 79. The Second Circuit left room for the use of such a clause, but held that "a higher level of specificity is required when attorneys' fees are being assessed against a plaintiff suing for securities fraud." *Id.* at 80.

Here we have just such a higher level of specificity: Every subscriber agreed to indemnify the sellers "from and against any losses, claims, damages, liabilities, [and] expenses (*including attorneys' reasonable fees and disbursements*) ... resulting from the untruth of any of the warranties" (emphasis added). The lack of notice that troubled the Second Circuit in *Zissu* just isn't a problem here. See *Barnebey v. E.F. Hutton & Co.*, 715 F.Supp. 1512, 1519-22 (M.D.Fla.1989).

More fundamentally, I question the majority's solicitude for these subscribers. These weren't mom and pop investors who mortgaged their retirement to buy palladium mines in Zanzibar. They weren't forced into the contract by economic duress; they weren't badgered by salesmen who pounded down their doors on Saturday morning. These were seasoned business people who commanded considerable resources. Many of them had substantial experience with horse breeding; some had already been doing business with Spendthrift.[1] Most retained independent investment

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[1] Typical is Robert Stratmore, an attorney who specialized in equestrian law and transactions, who grossed more than $15 million in thoroughbred trading the year of the Spendthrift offering and who holds lifetime breeding rights to Triple Crown winner Seattle Slew. See VII Joint ER, tab 20, exh. Q, at 149, 192. As defendants point out in their briefs, other subscribers included international fashion mogul Calvin

(continued...)

advisers and lawyers, and took their sweet time buying into the deal.[2] They risked what they warranted were disposable resources, hoping to get even richer. They gambled--and they lost.

Under these circumstances, what on earth does it mean to say the subscribers didn't have notice of the attorney's fee indemnity clause? It's axiomatic that a contract gives its signatories notice of what it says. We may blunt the cutting edge of this principle when one of the parties is illiterate, or subject to economic duress, or when we see legal filigree buried deep within a long, printed contract. But what justifies departing from this principle

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[1](...continued)
Klein; Zenya Yoshida, Japan's largest and most prominent horse breeder; and the Layman family, who has been involved with thoroughbred horses for over thirty years. See Defendants' Brief at 8 & n. 4.

[2] For example, Barry Schwartz asked his lawyer and investment advisor, Ralph Finerman, to review the PPM. IV Joint ER, tab 19, exh. D, at 20, 99, 103. Attorney Finerman holds a masters degree in taxation and is a CPA. *Id.* at 12. Finerman first heard about the Spendthrift placement on June 20, 1983, and began reviewing the documents the next day. Id. at 99, 103. Finerman carefully studied the agreement, *id.* at 103, and had several conversations with persons at Spendthrift about the deal, *id.* at 104-05. Finerman discussed the fruits of his research thoroughly with Schwartz before advising him to sign onto the deal. *Id.* at 118. Although Finerman made an initial, tentative decision around July 1st, 1983, VIII Joint ER, tab 22, exh. I, at 144, Schwartz didn't sign the agreement until July 13, 1983, three weeks after first receiving it. I Joint ER, tab 4, at 3. See also V Joint ER, tab 20, exh. F (George E. Layman, Jr., reviewed the deal with both an attorney and an accountant); IV Joint ER, tab 19, exh. E (Earl Schultz had two legal advisors, as well as the legal department of one of his companies, review the transaction before signing); VI Joint ER, tab 20, exh. P (Zenya Yoshida's attorney approved the deal).

here? If these subscribers can't be held to the terms of the contract they signed, who ever can?

D. We get a glimpse of what animates the majority's legal aerobics in the part of the opinion where they dispatch the sellers' suggested interpretation: "But if the indemnity clause is so interpreted to apply to the plaintiffs' lawsuit for oral misrepresentations, its literal terms would require the plaintiffs to pay the defendants' judgment and attorney's fees even if plaintiffs prevailed!" Maj. op. at 1352. The majority twice describes this as an absurd result, but nowhere really explores the issue. Which is too bad, because this is the meat of the coconut--the difficult public policy question at the heart of this dispute.

Before addressing this issue, however, I note that the majority does more than interpret the contract. By twice labelling the result suggested by the sellers as "absurd," the majority is saying it wouldn't enforce the clause even if the contract clearly and unambiguously provided what the sellers claim it does, and even if it gave ample notice to the subscribers. An absurd result, after all, remains absurd even if it's explicitly enshrined in the contract. The majority thus writes off what might be a perfectly acceptable and useful provision in a private placement agreement without even a close look. It would be far better if the majority confronted the issue squarely.

The majority's error begins and ends with its phrasing of the issue. After all, if you *assume* a securities law violation, it makes no sense to suggest that a defrauded plaintiff will have to indemnify the defrauding defendant by paying back the 10b-5 judgment plus attorneys' fees. But the whole purpose of a provision like the one we are construing is to forestall a 10b-5 violation by limiting the

information the investors rely on. Properly framed, the critical question here is: May sophisticated, well-counselled parties, using disposable assets, dealing at their leisure and from arms' length, limit by contract what information they will consider in making a major investment?

A perfectly respectable argument can be made that such a provision runs afoul of section 29(a) of the Securities Exchange Act of 1934, which states that "[a]ny condition, stipulation, or provision binding any person to waive compliance" with the federal securities laws and regulations is void. 15 U.S.C. § 78cc(a); see also *id.* § 77n. Enforcement of the indemnity provision could be seen as a waiver of the securities laws because it bars securities lawsuits based on misstatements of fact not contained in the offering materials. Rule 10b-5, after all, prohibits "any untrue statement of a material fact ... in connection with the purchase or sale of any security," not merely those made in the private placement memorandum. 17 C.F.R. § 240.10b-5 (emphasis added). Giving effect to the indemnity clause might prevent a meritorious securities action based on misrepresentations made by the promoters orally or in writings outside the formal offering package. An indemnity clause could thus be viewed as an end-run around the securities laws.

In fact, it's the very opposite. The whole point of requiring a written prospectus that conforms to the SEC's precise guidelines, see Reg.D, 17 C.F.R. §§ 230.501-.508, is to ensure that the parties rely on unbiased written data, not on half-whispered oral representations. Letting parties warrant that they are relying only on those offering materials serves this policy admirably: It forces potential subscribers to look closely at the written materials and avoids the

ambiguity and claims of fraud inevitably fostered by collateral oral promises. The warranty, moreover, focuses on reliance, the key element in establishing liability under Rule 10b-5. See *Basic, Inc. v. Levinson,* 485 U.S. 224, 243, 108 S.Ct. 978, 989, 99 L.Ed.2d 194 (1988) (misstatements lead to liability only if they're relied on); *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 206, 96 S.Ct. 1375, 1387, 47 L.Ed.2d 668 (1976) (same). Reliance is, by its nature, subjective; it's easily fabricated or distorted, particularly after the deal sours. Letting parties agree about what they will and will not consider in making a sophisticated, face-to-face securities investment would avoid the cost, uncertainty and delay of securities litigation that now turns on inherently unknowable mental processes.

Much is at stake here for everyone involved. This litigation--although it resulted in a complete defense victory, mostly on summary judgment--devoured a staggering quantity of productive resources. The record consists of 50 cubic feet of paper and weighs over half a ton. There were 4500 entries in the docket sheets below, including almost 400 orders and rulings by the district court. Fifty-seven briefs, consisting of nearly 1800 pages, were filed on appeal, yielding three published opinions. See *Schultz v. Hembree,* 975 F.2d 572 (9th Cir.1992); *McGonigle v. Combs,* 968 F.2d 810 (9th Cir.1992). Some 200 attorneys contributed to this conflagration, supported by legions of paralegals, summer associates and other staff. The attorneys' fees, for the seven defendants who requested them, amounted to more than $3.5 *million*. This says nothing of the fees incurred by the 13 plaintiffs and the 14 defendants who didn't request reimbursement; it doesn't take into account other litigation expenses such as photocopying, telephone, facsimile and messenger charges; deposition transcripts;

airfares, limousines and hotel rooms; power meals in swank restaurants. *See generally* Lisa Gibbs, *Skadden Calls Fee Routine; Florida Calls It Gouging*, American Lawyer, July/Aug.1991, at 19 (billing dispute involving, among other things, a $17 fee for courier delivery of a 75-cent newspaper).

Chasing down ephemeral oral representations may be great fun for the lawyers--and so profitable, too--but it does nothing to ensure the integrity or regularity of our securities markets. To the contrary, fear of this type of scorched earth litigation--the juridical equivalent of the firebombing of Dresden--will only discourage people like the sellers from entering into such transactions. That the plaintiffs were able to inflict major financial damage on their adversaries, using as their launch vehicle a case so thin it was never allowed to reach the jury,[3] will surely send a chill down the spine of anyone contemplating selling securities--or engaging in any other type of business--in our litigation-minded society. Assuming, as we must, that our national interest is served when financial markets function efficiently, unbeclouded by the risk of kamikaze litigation, a clear statement that we *will* enforce a subscriber's warran-

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[3] The case of Frank Bryant, a Spendthrift consultant, is particularly alarming. His defense was that he joined Spendthrift *after* the sale of the shares and was not in any way involved in the conception or drafting of the PPM. See e.g., X Joint ER, tab 28 (Declaration of Frank L. Bryant in Support of his Motion for Summary Judgment or Summary Adjudication of Issues). Defending on this theory, and winning summary judgment, Bryant was nonetheless saddled with approximately $900,000 in legal fees. See Declaration of Thomas K. Bourke in Support of Bryant's Motion for Award of Attorney's Fees from Casares and Schultz at 3-4. If this is the face of victory, how much uglier could defeat be?

ty he hasn't considered matters outside the offering materials would have an entirely salutary effect.

Doing so would inflict no injustice. The subscribers were sophisticated and obviously wielded substantial bargaining power. They got legal and financial advice galore before committing to the deal. See nn.1-2 supra. Had they relied on oral representations made by the sellers, they could (and should) have said so before the money was paid and the securities delivered. See Henry Klehm III, *Comment, Contractual Shifting of Defense Costs in Private Offering Securities Litigation,* 136 U.Pa.L.Rev. 971, 998-1002 (1988). I see no reason in the language or policies of the securities laws to make for them a softer bed than they've made for themselves.

That's why the majority's twice-asserted declaration of absurdity is entirely beside the (exclamation) point. Of course it would violate public policy, as well as the express terms of section 29(a), for parties to agree to pay back any damages they suffer under the securities laws. But it isn't nearly so absurd--indeed it makes considerable sense--to let parties limit by contract what they will and will not take into account when negotiating sophisticated financial transactions. The majority dismisses a lawful and potentially beneficial device by the use of a punctuation mark.

Conclusion

I agree that the district court applied an incorrect legal standard in ruling on Frank Bryant's request for attorneys' fees pursuant to section 11(e) of the Securities Act of 1933; accordingly, I concur in remanding for a determination of which claims the district court believes bordered on the frivolous. I also agree that the district court didn't abuse its discretion in refusing to award Bryant fees

under *Fed.R.Civ.Proc.* 11 and 37(c). But I strongly disagree with, and therefore dissent from, everything else in the majority opinion.

APPENDIX B

Robert D. STRATMORE, Plaintiff,

v.

Leslie COMBS II, et al., Defendants.
George E. LAYMAN, et al., Plaintiffs,

v.

Brownell COMBS II, et al., Defendants.
H. James GRIGGS, Plaintiff,

v.

Brownell COMBS II, et al., Defendants.
Zenya YOSHIDA, Plaintiff,

v.

Brownell COMBS II, et al., Defendants.
Fred L. FREDERICKS, Plaintiff,

v.

Brownell COMBS II, et al., Defendants.
John S. McGONIGLE, Plaintiff,

v.

Leslie COMBS II, et al., Defendants.
CENTRAL BANK AND TRUST COMPANY, Plaintiff,

v.

John F. McGONIGLE, et al., Defendants.
HAMILTON PARTNERS, et al., Plaintiffs,

v.

Leslie COMBS II, et al., Defendants.
Blas R. CASARES, Plaintiff,

v.

Brownell COMBS II, et al., Defendants.
Richard D. SCHULTZ, Plaintiff,

v.

Leslie COMBS II, et al., Defendants.

SPENDTHRIFT FARM, INC., Plaintiff,

v.

John F. McGONIGLE, et al., Defendants.

CONTINENTAL CASUALTY COMPANY, Plaintiff,

v.

Frank L. BRYANT, et al., Defendants.

Richard D. SCHULTZ, Plaintiff,

v.

Bateman EICHLER, et al., Defendants.

Russell E. CARLISLE, Plaintiff,

v.

SPENDTHRIFT FARM, INC., Defendant.

NORTHWOOD THOROUGHBRED INVESTORS, et al., Plaintiffs,

v.

Charles R. HEMBREE, Defendant.

Nos. C-86-0379-CAL, C-86-1692-CAL, C-86-3474-CAL, C-86-3673-CAL, C-86-3829-CAL,C-86-4129-CAL, C-86-6453-CAL, C-87-0228-CAL, C-87-1129-CAL, C-87-6038-CAL, C-88-0451-CAL, C-88-2577-CAL, C-88-3175-CAL, C-89-1342-CAL and C-89-1915-CAL.

MDL No. 710.

United States District Court,

N.D. California.

Sept. 28, 1989.

Vaughn R. Walker, Pillsbury, Madison & Sutro, San Francisco, Cal., and Stephen M. O'Brien III, Landrum, Shouse & Patterson, Lexington, Ky., for George E. Layman, et al., H. James Griggs and Zenya Yoshida.

John I. Alioto, Alioto & Alioto, San Francisco, Cal., for Robert D. Stratmore and John F. McGonigle.

Thomas E. Kotoske, Palo Alto, Cal., for Frederick L. Fredericks and Richard D. Schultz.

Kay S. Kuns, Santa Ynez, Cal., for Frederick L. Fredericks.

Richard M. Trautwein, Barnett & Alagia, Louisville, Ky., for Blas R. Casares.

Timothy L. Bouscaren, Benesch, Friedlander, Coplan & Aronoff, Cincinnati, Ohio, for Hamilton Partners.

Richard D. Rogovin and Robert D. Jacobs, Bricker & Eckler, Columbus, Ohio, for Richard D. Schultz.

Curt H. Mueller, Cooley, Godward, Castro, Huddleston & Tatum, San Francisco, Cal., and Lawrence Pedley, Pedley, Ross, Zielke & Gordinier, Louisville, Ky., for Brownell Combs, II.

Richard Haas, Lasky, Haas, Cohler & Munter, San Francisco, Cal., for Leslie Combs, II.

Boake Christense, McCutchen, Doyle, Brown & Enersen, San Francisco, Cal., and Jack G. Jones, Jr., Wyatt, Tarrant & Combs, Lexington, Ky., for Richard F. Broadbent, III and Bloodstock Research and Statistical Bureau.

Steven M. Umin, Williams & Connolly, Washington, D.C., for Bloodstock Research Information Services, Inc.

M. Laurence Popofsky, Heller, Ehrman, White & McAuliffe, San Francisco, Cal., for Charles R. Hembree and Kincaid, Wilson, Schaeffer & Hembree, P.S.C.

Ann G. Daniels and, Jerome I. Braun, Farella, Braun & Martel, San Francisco, Cal., for Spendthrift Farm, Inc. and Central Bank & Trust of Lexington.

Thomas K. Bourke, Riordan & McKinzie, Los Angeles, Cal., for Frank L. Bryant.

James E. Burns, Jr., Brobeck, Phleger & Harrison, San Francisco, Cal., for Bateman Eichler, Hill Richards, Inc. and Robert J. McGuinness.

Garth Guy, Columbus, Ohio, in pro. per.

Robert C. Vanderet, O'Melveny & Myers, Los Angeles, Cal., for Gibson, Dunn & Crutcher.

OPINION AND ORDER

LEGGE, District Judge.

These consolidated cases arose from the sale of securities of Spendthrift Farms, Inc. by certain defendants to plaintiffs in a private placement transaction. The complaints asserted claims under the federal securities laws, state securities laws, and common law. After extensive pretrial and trial proceedings, summary judgments or directed verdicts were granted in favor of some defendants, and the jury found in favor of the remaining defendants.

Some defendants counterclaimed against plaintiffs for the attorneys' fees they incurred in the defense of these cases, and they now move for summary judgment on those claims. Defendants Brownell Combs, II and Garth Guy

move to file similar counterclaims. Plaintiffs oppose those motions and themselves move for summary judgment against the counterclaims.

The issue addressed in this opinion is whether defendants can recover their attorneys' fees from plaintiffs under the terms of the Subscription Agreement, the document under which plaintiffs purchased their shares of Spendthrift.[1] This court has already denied defendants' motions and granted plaintiffs' motions in open court. This opinion is to record the court's reasons for that decision.[2]

I.

When plaintiffs expressed their interest in purchasing shares of Spendthrift, they received a lengthy private placement memorandum. The private placement memorandum included the Subscription Agreement. Those plaintiffs who purchased shares of Spendthrift were required to execute the Subscription Agreement and deliver it to Spendthrift and to the selling stockholders.

In paragraph number four of the Subscription Agreement, the purchasing plaintiffs were required to represent and warrant twenty-two facts and legal conclusions, spread over three pages of single spaced type. Construed as a whole, the representations and warranties were obviously intended to enable Spendthrift and the

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[1]There are no genuine issues of material fact in these motions. The decisions are made by construing the Subscription Agreement and by applying statutory and case law.

[2]Defendants also moved to recover their attorneys' fees under certain statutory provisions and under common law. This court has made a separate ruling on those motions, and they are not the subject of this opinion.

selling stockholders to preserve the private placement exemption under the Securities Act of 1933. However, some of the representations and warranties go beyond that objective.

Paragraph four is followed by an indemnification clause. That indemnification clause is what is at issue in these motions. The clause states as follows:

> 5. *Indemnification*. The foregoing representations and warranties are made by the Subscriber [plaintiff] with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber [plaintiff] hereby agrees that such representations and warranties shall survive his purchase thereof. *The Subscriber [plaintiff] hereby agrees to indemnify and hold harmless* the Company, the Sellers and agents of each of them [defendants] *from and against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements)*, judgements and amounts paid in settlement *resulting from the untruth of any of the warranties and representations contained herein*, or the breach by the Subscriber [plaintiff] of any of the covenants made by him herein. Notwithstanding the foregoing, however, no representation, warranty, acknowledgement or agreement by the Subscriber [plaintiff] made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

(Emphasis added). Defendants contend that by virtue of that clause they are entitled to recover from plaintiffs the reasonable attorneys' fees and costs incurred by defendants in their successful defense of this litigation. Defendants assert that, as a result of the judgments in defendants' favor and the testimony given by plaintiffs during the trial, plaintiffs have breached some of the representations and warranties contained in paragraph four. And defendants point to the provision of the indemnification clause which expressly provides for the recovery of reasonable attorneys' fees and disbursements.

The court need not discuss each of the representations of warranties which were allegedly breached by plaintiffs during the course of this litigation. Some of the breaches are admitted. And the court will assume that the representations or warranties alleged by defendants were breached by plaintiffs. The court does note, however, that the breaches did not result in the loss of the private placement exemption. Defendants' claims are not based on any loss of that exemption, but instead defendants seek to recover their attorneys' fees and costs incurred in the successful defense of these cases.

II.

In general, contracts for indemnity and the recovery of attorneys' fees and costs are enforceable. *Wagner v. Benson,* 101 Cal.App.3d 27, 36, 161 Cal.Rptr. 516, 522 (1980); *Michael-Regan Co., Inc. v. Lindell,* 527 F.2d 653, 656-58 (9th Cir.1975). The problem here is that this general principle of enforceability overlaps with, and indeed conflicts with, a policy of the federal securities laws expressed by both statutes and case law. That policy is to preserve the power of securities purchasers to enforce their

rights under the securities laws. As a result of that policy, courts have approached with caution agreements which could waive or restrict those rights of enforcement. Research has disclosed no authority in this circuit which directly resolves this conflict.

This court concludes that the indemnity agreement at issue here does not encompass the right of defendants to recover their attorneys' fees expended in their successful defense. The court reaches that conclusion by interpretation of the indemnity clause itself, and by the application of the federal policy. This court does not conclude that *no* indemnity agreement could *ever* shift the expenses of a successful defense to securities plaintiffs. Rather, this decision is based upon the court's interpretation of *this* indemnity agreement, against the backdrop of the public policy expressed by the statutes and the cases.

III.

First, the language of the indemnity clause itself:

As stated, the representations and warranties made in paragraph four--the breach of which triggers the indemnification clause in paragraph five--are primarily intended to preserve the private placement exemption. That intent is not derived just from paragraph four, but also from the first sentence of the indemnification clause. It states that the representations and warranties are made "with the intent that they may be relied upon in determining [plaintiff's] qualification and suitability to purchase shares." This language is to protect Spendthrift and the selling shareholders from the consequences of a plaintiff being unqualified, or the shares being unsuitable for his investment, and hence the private placement exemption being lost.

The indemnity clause is also sensitive to not requiring the purchasers to waive their rights under the federal or state securities laws. This is stated in the last sentence of the clause, which provides that in spite of the agreement to indemnify,

> "no representation, warranty, acknowledgment, or agreement by [plaintiff] made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws."

The sentence can be interpreted as meaning that if a purchaser does sue for alleged violations of the securities laws, all rights and remedies would be governed by those laws and not by the terms of the indemnity clause. That is a reasonable interpretation in light of the statutory and case law which the court will now discuss.

IV.

Under section 14 of the Securities Act of 1933, 15 U.S.C. § 77n, securities purchasers cannot waive the sellers' compliance with the securities laws. The last sentence of this indemnification clause preserves that position, and the clause is expressly not such a waiver. In light of that statutory provision, courts have been careful in securities cases to preserve the rights of private action under the securities laws. But the results have not been uniform.

Some cases have enforced indemnity clauses in litigation involving securities. The court in *Tartell v. Chelsea National Bank*, 351 F.Supp. 1071, 1079 (S.D.N.Y.1972) *aff'd*, 470 F.2d 994 (2d Cir.1972) (*per curiam*), enforced an attorneys' fees provision against the maker of a note who had unsuccessfully sued the lender for

securities fraud. And the court in *Samuels v. Wilder,* 871 F.2d 1346 (7th Cir.1989), enforced an indemnity clause which read:

> The Owner [plaintiff] agrees to indemnify the Nominee, his successors, and assigns, and to hold Nominee harmless from all liability, loss, expenses, damages, costs and attorney's fees that Nominee may at any time incur by reason of any type of inquiry, action or suit which may be brought against him or made of him by any person, firm, corporation, or governmental agency or authority or anyone else by reason of the nomineeship.

Id. at 1348. The *Samuels* court, applying state law and without discussing federal securities law, interpreted the clause as a standard indemnity provision and required plaintiff to reimburse the Nominee for the attorneys' fees it spent defending plaintiff's action for securities fraud and misrepresentation. *Id.* at 1352. To the extent that *Tartell* and *Samuels* involved interpretation of the language of specific indemnity clauses, they are of course not controlling on the clause at issue here.

The strongest position against enforcement of such indemnity provisions was stated in *Doody v. E.F. Hutton & Co.,* 587 F.Supp. 829 (D.Minn.1984). The plaintiffs represented in purchasing the securities that they had relied only upon the offering documents. They then sued under the securities laws for alleged oral misrepresentations, and were unsuccessful. The subscription agreement contained the following indemnity clause:

> [each plaintiff agreed] to indemnify and hold harmless the Partnership, the General Partner, its affiliates and participating broker-dealers from and against all damages, losses, costs and expenses (including reasonable attorneys' fees) which they may incur by reason of ... any breach of the representations and warranties made by the undersigned herein....

Id. at 831. The *Doody* court held:

> The Court finds that enforcing an indemnity provision such as the one in the instant action would discourage prospective plaintiffs from bringing securities fraud actions whenever there is an integration clause in a subscription agreement. Prospective plaintiffs would be discouraged because the plaintiffs would be running the risk of incurring substantial liability for attorneys' fees and costs. *Since the securities laws are a remedial measure intended to encourage the prosecution of securities fraud actions, the Court refuses to enforce this indemnity provision.*

Id. at 833 (emphasis added).

Other courts have not taken such an absolute stance, recognizing a seller's legitimate interest in receiving accurate information from a buyer, particularly in order to conduct a private placement offering. The court in *Barnebey v. E.F. Hutton & Co.*, 715 F.Supp. 1512 (M.D.Fla.1989), distinguished the *Doody* court's analysis, quoting with

approval the lower court's decision in *Zissu v. Bear Stearns & Co.*:[3]

> [i]f this indemnification agreement is not enforceable, it would undermine the securities laws to the extent that investors would be free to make misrepresentations with impunity and issuers would be wholly unable to accurately assess the qualifications of potential investors in risky ventures such as this one.

Id. at 1522. The *Barnebey* court did not actually give effect to the indemnity provision, however; it denied the plaintiff's motion to declare the indemnity clause unenforceable on public policy grounds.

The most specific case regarding the indemnity at issue here is *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75 (2d Cir.1986). Plaintiff sued under the securities laws, based in part on alleged oral misrepresentations. Plaintiff had warranted in his subscription agreement that he had relied only upon the written offering materials, and he agreed to indemnify and hold defendants harmless "against any and all loss, damage or liability due to or arising out of a breach of any representation or warranty." Plaintiff lost his suit, and defendants counterclaimed for their attorneys' fees based on that indemnity agreement. The *Zissu* court stated that contracts allowing recovery of attorneys' fees in securities suits did not violate the securities laws *per se*. However, the court declined to award defendants their attorneys' fees based on that indemnity agreement. The court explained:

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[3]627 F.Supp. 687 (SD NY1986); but see 805 F.2d 75 (2d Cir.1986).

> The clause *Zissu* signed did not put him on notice that he would be responsible for defendants' legal fees incurred in the security fraud suit. In fact, no mention of attorney's fees was made in the indemnification clause. Instead, the warranties in question were necessary to exempt the limited partnership from the requirements of the 1933 Act and are so understood by investors. That being the case, the parties had little reason to expect that such warranties might also be the basis for the counterclaim made in the present case. Thus, although New York courts have held that contractual indemnity provisions for attorney's fees will be enforced, and broad indemnification provisions like the one here should be read to extend to such fees, *a higher level of specificity is required when attorneys' fees are being assessed against a plaintiff suing for securities fraud.*

Id. at 79-80 (citations omitted) (emphasis added).

A similar position was stated in "*Contractual Shifting of Defense Costs in Private Offering Securities Litigation,*" 136 U.Pa.L.Rev. 971 (1988), in which the author concludes:

> Sellers of private offerings claiming an exemption from the registration provisions of federal securities law should be entitled to enforce indemnification clauses included in the subscription documents in the proper circumstances. To be eligible to do so, the seller must have complied fully with federal

> securities laws, *including disclosing the existence and effect of the indemnification clause.*

Id. at 1002 (emphasis added).

Congress has long provided that the proper balance between protecting investors and promoting capital formation is reached by full disclosure of the risks involved in an investment. Full disclosure is at the heart of the federal securities laws. *Id.* at 974. The same principle should apply in the context of indemnification agreements in securities purchases. Sellers should not be absolutely barred from enforcing by indemnity agreements the warranties and representations made by buyers. However, as the *Zissu* court stated, if those indemnity provisions are to include defendants' attorneys' fees incurred in suit by buyers for securities laws violations, such an inclusion should be very clear.

Defendants here argue that this indemnity clause explicitly mentions attorneys' fees, unlike the one in *Zissu*. Therefore, defendants believe that this indemnity provision was specific. However, the reasoning in *Zissu* went beyond the mere presence or absence of the words "attorneys fees" in the clause. The court pointed out that the main purpose of the warranties and representations was to protect the private placement exemption, as it is here. In that context, plaintiffs had little reason to anticipate that the indemnity provision would apply to suits by the buyers themselves against the sellers for securities act violations.

Finally, as already noted, the last sentence of the indemnity clause provides that plaintiffs do not waive their rights under the securities laws. One of those rights is that they are not liable for attorneys' fees unless their suit is

frivolous. 1933 Securities Act § 11(e), 15 U.S.C. § 77k(e). If the indemnity clause is to impose upon them liability for attorneys' fees on a different basis, that statement should be explicit.

V.

In summary, the court concludes that the indemnity clause here did not explicitly provide that plaintiffs would be liable for defendants' attorneys' fees in the event of an unsuccessful securities law suit by plaintiffs, and the clause therefore may not be enforced in that manner.

IT IS THEREFORE ORDERED that:

1. Defendants' motions for summary judgment to enforce the indemnity clause of the Subscription Agreement are denied;

2. Plaintiffs' motions for summary judgment to preclude enforcement of the indemnity clause are granted; and

3. The motions of defendants Combs and Guy for leave to file counterclaims based upon the indemnity clause are denied.

Dated: September 28, 1989

/s/

CHARLES A. LEGGE
UNITED STATES DISTRICT JUDGE

APPENDIX C
UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
LEXINGTON

CIVIL ACTION NO. 90-131

BROWNELL COMBS II, *PLAINTIFF,*

V.

ZENYA YOSHIDA, et al., *DEFENDANTS*

MEMORANDUM OPINION AND ORDER

In 1983, plaintiff Brownell Combs offered to sell 175,000 shares of common stock in Spendthrift Farm Incorporated, a thoroughbred horse farm, to defendant Zenya Yoshida, a Japanese horseman who conducts his thoroughbred business in the United States under the name Shadai Farm. The purchase price for the stock was $1,750,000.00. As part of the transaction, defendant was required to review a "private placement memorandum" and sign a "subscription agreement". This was necessary, in part, to enable Spendthrift to retain its private placement registration exemption under 17 C.F.R. §§ 230.501-508.

One of the conditions of the private placement registration exemption is that any purchaser of the exempt security be "sophisticated" such that the purchaser has: a minimum net worth, knowledge and experience in investment matters, a capability of evaluating the risks and merits of the investment, access to the issuer's books and records, no intent to resell the exempt security, and an opportunity to ask questions and receive answers. 17 C.F.R. §§ 230.501, 502 and 506. The subscription agreement signed by defendants in connection with the sale of Spendthrift stock

contained numerous warranties, several of which mirrored the sophistication requirements. When he signed the subscription agreement, Yoshida warranted, among other things: a) that he had received and read the private placement memorandum; b) that all relevant documents concerning Spendthrift had been made available to him; c) that he could adequately evaluate the merits and risks of his investment in Spendthrift; d) that he understood there were restrictions on the transferability of the stock in Spendthrift; e) that he was not relying on any representations other than those in the private placement memorandum; and, (f) that he understood the financial information in the private placement memorandum was not audited, and that no provision had been made for deferred taxes.

In 1986, Yoshida and others filed a securities fraud lawsuit in the United States District Court for the Northern District of California, against Combs and others, alleging fraud, negligent misrepresentation, and violations of various state and federal securities laws, all in relation to the sale of Spendthrift stock. The suit took eleven weeks to try, and at its conclusion, the jury returned a verdict in favor of Combs and the others named. It is not seriously disputed, and in fact was a finding of the California District Court, that during the course of the California lawsuit, defendant breached several of the warranties contained in the subscription agreement. *Stratmore v. Combs,* 723 F. Supp. 458, 460 (N.D. Cal. 1989).[1]

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[1] For example, in the California suit, defendant alleged that he relied on oral representations made by the sellers when he purchased the Spendthrift stock. However, as part of the subscription agreement, defendant had warranted that he did not rely on any representations other that those contained in the private placement memorandum.

Also during the California suit, many of the named parties counterclaimed for attorneys' fees, costs, and other damages based on an indemnity clause in the subscription agreement. Combs did not initially assert a counterclaim, but after the jury's verdict in the case in chief, he moved to file a counterclaim similar to those asserted by the other parties. In its *Stratmore* opinion, the District Court for the Northern District of California dismissed the existing counterclaims, and denied Combs leave to file his counterclaim. This decision was affirmed by a divided panel of the Ninth Circuit Court of Appeals in *Layman v. Combs*, 981 F.2d 1093 (9th Cir. 1992).

Plaintiff initiated the present suit shortly after the *Stratmore* decision to advance basically the same claims that he attempted to advance by way of counterclaim in California. This action was filed in the Eastern District of Kentucky based in part on plaintiff's assertion that defendant signed the subscription agreement in Fayette County, Kentucky (located within the Eastern District of Kentucky), and that the subscription agreement was accepted by plaintiff in Fayette County.

Recovery of attorneys' fees, costs, and damages is sought by plaintiff under paragraph five of the subscription agreement, referred to as the indemnity clause:

> 5. *Indemnification*. The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the subscriber hereby agrees that such representations and warranties shall survive his purchase thereof.

> The Subscriber hereby agrees to indemnify and hold harmless the Company, the Sellers, and agents of each of them from and against any losses, claims, damages, liabilities, expenses (including attorney's reasonable fees and disbursements), judgments and amounts paid in settlement resulting from the untruth of any of the warranties and representations contained herein, or breach by the Subscriber of any of the covenants made by him herein.
>
> Notwithstanding the foregoing, however, no representation, warranty, acknowledgement or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

Plaintiff claims that as a result of defendant's breaches of the warranties contained in the subscription agreement, he suffered damages, including attorney's fees for the ten-week California suit, in the amount of $101,000,000.00, plus interest[2] Plaintiff also seeks punitive damages in the amount of $200,000,000.00. Named defendants are Yoshida and Shadai Farms (singularly referred to as defendant).

Because of the pendency of the *Stratmore* appeal, this case was initially stayed, and later dismissed without prejudice to refile following a final decision by the Ninth Circuit. When the case was dismissed without prejudice to

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[2] In his original complaint, plaintiff advanced a second cause of action claiming wrongful use of civil proceedings. This claim was previously dismissed by the Court as settled.

refile, cross motions for summary judgment were pending. These motions were also dismissed without prejudice to renew. The Ninth Circuit's decision in *Layman* was handed down on December 17, 1992, and on January 19, 1993, the parties' were granted leave to redocket this case and to refile their cross motions for summary judgment. Also, the parties were directed to supplemental their motions in light of the *Layman* decision. These supplemental pleadings have been filed and the renewed cross motions for summary judgment are now fully submitted.

Defendant seeks dismissal of this case based on two arguments: 1) that under the federal securities laws, recovery of costs should be permitted only if it is found that the underlying lawsuit lacked merit; and, 2) that the indemnity clause was only designed to apply to situations where plaintiff's private placement registration exemption was lost.

1. Costs under the securities laws:

Defendant points out that the third sentence of the indemnity clause provides that he retains all rights under federal and state securities laws. One of those rights, says defendant, is that a plaintiff in a securities lawsuit is liable for costs only if the suit lacks merit. 15 U.S.C. § 77k(e).

In advancing this argument, defendant adds words to the statute that it does not contain. The relevant portion of § 77k(e) reads "costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit." Nowhere in § 77k(e) does the word *only* appear, and this Court will not add the word *only* by judicial fiat. Absent any explicit statutory language or any supportive case law (defendant has cited none), the Court cannot conclude that assessment of costs is *only*

proper upon a finding that the defendant's prior claims lacked merit.[3]

2. The intent of the indemnity clause:

Defendant also argues that the indemnity clause, when placed in the context of the entire document, is limited to untrue representations that result in a loss of the registration exemption. In support of this argument, defendant notes that many of the warranties in the subscription agreement track verbatim the language of 17 C.F.R. §§ 230.501-508, which sets out the sophistication requirements of the registration exemption. Further, the private placement memorandum states that the suitability standards set forth in the subscription agreement "are designed to ensure compliance with [the registration exemption prerequisites]." Defendant concludes, and would have this Court find as a matter of law, that since Spendthrift did not lose its registration exemption as a result of defendant's actions, the indemnity clause is not applicable.

For this conclusion, defendant draws support from the rulings of the District Court in California, and the majority of the Ninth Circuit Court of Appeals. In affirming *Stratmore*, the *Layman* court held that the "expressed intent of the [indemnity] clause is that any investor whose breach of a representation causes the sellers to lose their private

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[3] Even if the statute did provide that costs could only be assessed by the Court if it believes the suit to have been without merit, plaintiff would not be foreclosed from recovery under the indemnity clause. Section 77k(e) applies to a court-ordered assessment of costs. In this case, the conditions concerning the payment of costs were set out in an agreement between the parties. If costs are to be paid be defendants, it would not be through a court-ordered assessment, but rather becasue such paument is mandated by the parties' own agreement.

placement exemption is obliged to reimburse the sellers for their losses. . . . a reasonable investor who read the PPM [private placement memorandum] and the subscription agreement would so interpret the indemnification clause." *Layman*, 981 F.2d at 1100.

This Court has reviewed the record and the documents under dispute and cannot find as a matter of law that the indemnification clause is limited to situations where Spendthrift looses its registration exemption. In arriving at this conclusion, this Court was mindful that under Kentucky law, the right to recovery pursuant to an indemnity contract is "well recognized", and indemnity contracts "[are] not against public policy and will be enforced if the indemnitee has suffered loss thereunder and has complied with its terms." *U.S. Fidelity & Guar. Co. v. Napier Elec.*, 571 S.W.2d, 644, 646 (Ky. App. 1978), quoting *National Surety Corp. v. Peoples Milling Co.*, 57 F.Supp. 281, 282 (W.D.Ky. 1944).

Although this Court has been unable to discover any Kentucky cases dealing with an indemnity clause similar to the one presently under consideration, cases exist in other jurisdiction where such indemnity clauses have been examined. These other jurisdictions are split as to their conclusions regarding the enforceability of the indemnity clauses, and it cannot be said that any clear majority rule exists. Compare *Stratmore v. Combs,* 723 F. Supp. 458 (N.D. Cal. 1989) and *Layman v. Combs*, 981 F.2d 1093 (9th Cir. 1992) with *Zissu v. Bear, Stearns & Co.*, 627 F. Supp. 687 (S.D.N.Y. 1986) *aff'd on other grounds*, 805 F.2d 75 (2d Cir. 1986), and *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1512 (M.D.Fla. 1989). These decisions have clearly set out many of the general arguments for and against

enforcement of indemnity clauses like the one at the center of this case, and it is unnecessary for this Court to restate those arguments. Instead, in light of Kentucky's well recognized policy of upholding the right of recovery under indemnity contracts, this Court has considered the specific facts of this case, and the specific wording of the clause under dispute.

This Court cannot ignore the fact that several of the warranties contained in the subscription agreement and referred to in the indemnity clause do not track the requirements of 17 C.F.R. §§ 230.501-508. These additional warranties go beyond those required by the securities laws. *See Layman*, 981 F.2d at 1105. A ruling that the indemnification clause is limited as asserted by defendant would nullify the additional warranties, which were agreed to by the parties, and which were just as much a part of the subscription agreement as were those warranties which track the regulations. Even if it were so inclined, which it is not, the Court has been shown no authority which would allow it to edit the subscription agreement in the manner suggested by defendant.

It is also apparent that the plain language of the indemnity clause does not limit indemnification to the situation where the registration exemption is lost, and, in fact, makes no mention at all of the registration exemption. Although Spendthrift's desire to retain the registration exemption was certainly one of the reasons for the inclusion of the warranties and the indemnity clause, nothing contained in the clause itself, or in the other relevant documents make the indemnity clause exclusively operative in cases of the loss of the registration exemption. The books are full of cases where sellers of securities have been sued

by disappointed investors claiming "But, I didn't know", "But, you didn't tell me", or "But, I had no reason to believe this investment was inappropriate for me." The plain language of the indemnity clause does not foreclose Spendthrift's intention to insulate itself from such claims.

The first sentence of the indemnity clause refers generally to a potential buyer's "qualification and suitability to purchase". The defendant would have this Court conclude that this phrase refers solely to the question of whether a potential buyer is qualified and suitable to purchase without causing Spendthrift to loose its registration exemption. Again, defendant attempts to add words where those words simply do not exist. The court is not inclined to rewrite the subscription agreement and include an explanation of the purpose of the indemnity clause, *at this point in the case.* We can only find that the express language of the indemnity clause, when viewed in the context of the entire document, is not as a matter of law limited to situations where Spendthrift's registration exemption is lost by a buyer's breach of the warranties of the subscription agreement.

The Court recognizes that a rational finder of fact could interpret the first sentence as does defendant. However, in light of the additional warranties of the subscription agreement, and the broad language of the indemnity clause, the Court finds that a rational trier of fact could also conclude that the indemnity clause was not limited to situations where the registration exemption was lost. For these reasons, issues of material fact exist, and defendant's motion for summary judgment must be denied.

For these same reasons, plaintiff's motion for partial summary judgment must also be denied. Plaintiff would have this Court hold that defendant's undisputed breach of

the warranties of the subscription agreement requires, as a matter of law, that he be indemnified pursuant to the second sentence of the indemnity clause. However, this position presupposes that the indemnity clause is applicable in the present situation and that the parties did not intend to limit the application of the indemnity clause as asserted by defendant. As set out above, the applicability of the indemnity clause is an issue for the trier of fact and thus cannot be decided on motions for summary judgment. Plaintiff's motion for partial summary judgment will also be denied, and this case shall be placed on a trial schedule by subsequent orders of the Court.

Accordingly,

IT IS THEREFORE ORDERED AND ADJUDGED:

(1) That defendant's motion for summary judgment is DENIED;

(2) That plaintiff's motion for partial summary judgment is DENIED;

This 4th day of June, 1993.

HENRY R. WILHOIT, JR., JUDGE

APPENDIX D

15 U.S.C. § 77k

UNITED STATES CODE

TITLE 15. COMMERCE AND TRADE

CHAPTER 2A--SECURITIES AND TRUST INDENTURES

SUBCHAPTER I--DOMESTIC SECURITIES

§ 77k. Civil liabilities on account of false registration statement

(a) Persons possessing cause of action; persons liable

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue--

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement

made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Persons exempt from liability upon proof of issues

Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof--

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission

and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a

fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) Standard of reasonableness

In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) Effective date of registration statement with regard to underwriters

If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) Measure of damages; undertaking for payment of costs

The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That

if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) Joint and several liability

All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally

liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) Offering price to public as maximum amount recoverable

In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

APPENDIX E

15 U.S.C. 78cc

UNITED STATES CODE

TITLE 15. COMMERCE AND TRADE

CHAPTER 2B--SECURITIES EXCHANGES

§ 78cc. Validity of contracts

(a) Waiver provisions

Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

(b) Contract provisions in violation of chapter

Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: Provided, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (3) of

subsection (c) of section 78o of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) or (2) of subsection (c) of section 78o of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation. The Commission may, in a rule or regulation prescribed pursuant to such paragraph (2) of such section 78o(c) of this title, designate such rule or regulation, or portion thereof, as a rule or regulation, or portion thereof, a contract in violation of which shall not be void by reason of this subsection.

(c) **Validity of loans, extensions of credit, and creation of liens; actual knowledge of violation**

Nothing in this chapter shall be construed (1) to affect the validity of any loan or extension of credit (or any extension or renewal thereof) made or of any lien created prior or subsequent to the enactment of this chapter, unless at the time of the making of such loan or extension of credit (or extension or renewal thereof) or the creating of such lien, the person making such loan or extension of credit (or extension or renewal thereof) or acquiring such lien shall have actual knowledge of facts by reason of which the making of such loan or extension of credit (or extension or renewal thereof) or the acquisition of such lien is a violation of the provisions of this chapter or any rule or regulation thereunder, or (2) to afford a defense to the collection of any debt or obligation or the enforcement of

any lien by any person who shall have acquired such debt, obligation, or lien in good faith for value and without actual knowledge of the violation of any provision of this chapter or any rule or regulation thereunder affecting the legality of such debt, obligation, or lien.

APPENDIX F

SUBSCRIPTION AGREEMENT

INSTRUCTIONS: A Subscriber to Spendthrift Farm, Inc., should deliver the following to Leslie Combs II, Brownell Combs II, Spendthrift Farm, Inc.; P.O. Box 996; Lexington, Kentucky 40588, directly:

(a) two completed, executed and notarized copies of the Signature Page which Signature Page is part of Appendix D-4 to the Private Placement Memorandum dated April 1, 1983 (the "Memorandum");

(b) a check in the amount of $1,000,000 with respect to each Unit purchased payable to Central Bank & Trust Company, Lexington, Kentucky, Escrow Account-Spendthrift offering.

(c) an executed Purchaser Questionnaire (Appendix D-2 to the Memorandum);

(d) if required, an executed Purchaser Representative Questionnaire (Appendix D-3) to the Memorandum); and,

(e) an executed Acknowledgement of Receipt of the Memorandum (Appendix D-1) to the Memorandum).

Subscriptions for shares must be received on or prior to June 30, 1983, unless the Seller, in its sole and absolute discretion, extends that date through a date not later than September 30, 1983. The Seller reserves the right to reject any subscriptions in its absolute and sole discretion, and to allot to any prospective investor less than the number of shares applied for by such investor. The Seller may modify or terminate this offering at any time prior to the acceptance of any subscription.

The undersigned (the "Subscriber") hereby offers to purchase a number of units (the "Units") set forth on the Subscriber's Signature Page representing shares in the Company, a Kentucky corporation, on the terms and conditions set forth in the Memorandum.

1. *Subscription*. The Subscriber subscribes to the number of Units indicated on the Signature Page submitted to the Sellers, at a purchase price of One million dollars, ($1,000,000) each.

2. *Acknowledgement of Receipt of Memorandum*. The Subscriber acknowledges receipt of the Memorandum, by executing the Acknowledgement of Receipt of the Memorandum (in the form set forth in Appendix D-1 to the Memorandum). The Subscriber agrees to be bound by the terms and conditions of an investment in the shares set forth in the Memorandum, subject only to acceptance of this subscription by the Sellers.

3. *Binding Effect of Subscription*. The Subscriber acknowledges that the Sellers will rely on this Subscription Agreement and accordingly acknowledges that on delivery of this executed Subscription Agreement, by delivery of the Signature Page, the Subscriber will become bound by its terms. This Subscription Agreement cannot be revoked, cancelled or terminated by the Subscriber after expiration of any applicable recession period under state law and, unless his subscription is rejected or the offering of shares in not consummated, the Subscriber will become a shareholder in the Company.

4. *Representations and Warranties*: The Subscriber hereby represents and warrants that:

(a) he is financially able to bear the economic risk of his investment subscribed hereunder for an indefinite period of time with no return thereon; he can afford a complete loss of his investment in the shares; he has adequate means of providing for his current needs and foreseeable future contingencies without regard to this particular investment, and anticipates no need in the foreseeable future to sell the shares for which he hereby subscribes; and he does not have an overall commitment to investments that are not readily marketable that is disproportionate to his net worth and this investment will not cause his investments that are not readily marketable to become disproportionate to his net worth;

(b) if he is a natural person, at the time of making his investment he has a net worth or joint worth with his spouse in excess of $5,000,000.00; or,

(c) if it is an entity, each of the equity owners thereof satisfies the requirements of clause (b) above;

(d) if it is a corporation or other organization, it has at the time of making the investment total assets in excess of $5,000,000.00;

(e) he has received and read and is familiar with the Memorandum including each of the exhibits annexed thereto and any amendments thereof, and he confirms that all documents, records and books pertaining to his proposed investment in the Company have been made available to him and/or his Purchaser Representative (as defined in Rule 501 promulgated under the Securities Act of 1933, as amended (the "1933 Act");

(f) he has, either alone or with his Purchaser Representative, if any, such knowledge and experience in financial

and business matters that he is capable of evaluating the merits and risks of the prospective investment in the Units of common stock in the Company;

(g) he and/or his Purchaser Representative has had an opportunity to ask questions of and receive answers from the Sellers, or any person or persons acting on behalf of the Sellers, concerning the terms and conditions of this investment in the Units, and all such questions have been answered to his full satisfactions and/or that of his Purchaser Representative;

(h) he and/or his Purchaser Representative has carefully reviewed and fully understands the information contained in or attached as an exhibit to the Memorandum; he understands that any assignment of shares, in whole or in part, is subject to substantial restrictions contained in the Memorandum; he further understands that there will be no market for the shares, and accordingly it may be not possible for him to readily liquidate his investment therein if he should need or desire to do so;

(i) he is purchasing his shares solely for his own personal account for investment only, and not with a view to reselling, distributing, splitting, sharing or otherwise disposing of same; he has no arrangement or commitment, formal or informal, with any person(s) to sell, transfer or pledge same or any part thereof, and he has no present plans to enter into any such arrangement or commitment; he understands the legal consequences of the foregoing representations and warranties to mean that he must bear the economic risk of his investment in the shares for an indefinite period of time because the shares have not been registered under the 1933 Act or any state securities laws, and cannot be sold unless subsequently registered under the

1933 Act or any applicable state securities laws, unless an exemption from registration should be available (as to which there is no assurance);

(j) he will not sell, transfer, assign or otherwise dispose of his shares, without having delivered to the Sellers, if so requested, an unqualified opinion of counsel, in form and substance satisfactory to the Sellers, that the proposed disposition complies with the 1933 Act and any applicable federal and state securities laws and regulations;

(k) he understands that the Sellers and the Company in offering the shares for sale without registration are relying upon the truth and accuracy of the representations and warranties made by him in this Subscription Agreement, and in the Purchaser Questionnaire submitted by him to the Sellers and the Purchaser Representative Questionnaire of his Purchaser Representative, if any; and that he is required, upon request of the Sellers, to provide such information as may be necessary to substantiate the accuracy of such representations and warranties;

(l) he understands that in view of the Securities and Exchange Commission (the "Commission") the statutory basis for the exemption claimed would not be present if, notwithstanding each investor's representations and warranties, any of the investors has in mind merely acquiring any of the Units for resale upon the occurrence of non-occurrence of some predetermined event or if any investor is not financially responsible;

(m) it has been called to his attention both in the Memorandum and by those individuals with whom he has dealt in connection with his investment in the shares that his investment in the Company involves a substantial degree of financial risk;

(n) he has received no representations or warranties from the Sellers or any of the Sellers officers, directors, employees or agents other than those contained in the Memorandum;

(o) by virtue of his own knowledge and experience in financial and business matters, he is capable of evaluating the merits and risks of making an investment in the Company, or, in the alternative, he has indicated the name and address of his Purchaser Representative(s) in the space provided in the Signature Page and he and his Purchaser Representative together have such knowledge and experience, and are therefore capable of evaluating the merits and risks of making this investment; and,

(p) he will use the Memorandum solely for his own review and will not further distribute it except to his designated Purchaser Representative(s), if any;

(q) he recognizes that no State or Federal government authority has made any finding or determination relating to the fairness for investment of the Shares and that no State or Federal government authority has recommended or endorsed or will recommend or endorse an investment in the Shares;

(r) he understands that the Offering of the Shares has not been reviewed by any official of any State because of the Seller's representations that this is intended to be an offering that is exempt from registration under the 1933 Act and that is non public pursuant to Rules 505 and 506, respectively, promulgated under the 1933 Act and that if all of the conditions and limitations of said rules are not compiled with, the Offering may be submitted to such officials for amended exemption. He understands that any offering literature used in connection with the Offering has

not been prefiled with or reviewed by any state official. He further understands that the books and records of the Company will be available upon reasonable notice for inspection by Subscribers during reasonable business hours at the principal place of business of the Company.

(s) he agrees not to transfer or assign this Subscription or any interest therein and agrees that it this Subscription is accepted, the assignment and transferability of the Shares subscribed by him will be governed by all applicable laws;

(t) if the undersigned is a partnership, consisting of one or more trusts and/or one or more individuals and/or one or more corporations, each of the partners will sign the Signature Page by authorizing the Subscriber to so sign on behalf of such partnership and, by so signing, each such partner represents and warrants that (i) each of the representations or agreements or understandings set forth herein applies to that partner, and (ii) the person who has signed on behalf of the partnership identified as the Subscriber is authorized to so sign; in the case of any partner that is a trust, a trustee (or co-trustee) of the trust is authorized by the trust agreement to make this investment and to enter into this Subscription Agreement; and in the case of any partner that is a corporation, the corporate officer so signing is authorized to sign on behalf of the corporation and will, upon request of the Company or counsel to the Company, furnish to the Company not only the appropriate language of the Articles of Incorporation or By-Laws, or both, authorizing the corporation to make such investment, but also appropriate corporate minutes authorizing the specific investment;

(u) he further understands that no assurances can be given that the financial results of operations will be achieved by the Company.

(v) SUBSCRIBER ACKNOWLEDGES THAT HE UNDERSTANDS THAT THE FINANCIAL INFORMATION PRESENTED IN THE MEMORANDUM IS UNAUDITED AND THAT NO PROVISION HAS BEEN MADE FOR DEFERRED TAXES.

5. *Indemnification*. The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber hereby agrees that such representations and warranties shall survive his purchase thereof. The Subscriber hereby agrees to indemnify and hold harmless the Company, the Sellers and agents of each of them from and against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements), judgements and amounts paid in settlement resulting from the untruth of any of the warranties and representations contained herein, or the breach by the Subscriber of any of the covenants made by him herein. Notwithstanding the foregoing, however, no representation, warranty, acknowledgement or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

6. *Limitation on Assignment of Shares*. The Subscriber acknowledges that he is aware that there are substantial restrictions on the assignability of the Shares. Since the Shares will not be registered under the 1933 Act or any applicable State securities laws, and the Subscriber has no right, other than the rights designated in the Memo-

randum, to require that they be so registered, the Shares may not be and the Subscriber agrees that they shall not be, sold, transferred, or otherwise disposed of unless such sale, transfer, or disposition does not require registration under the 1933 Act or any applicable State securities laws. The Subscriber also acknowledges that he shall be responsible for compliance with all conditions on transfer imposed by the 1933 Act, any applicable State securities laws or any securities law administrator, and will hold the Company and the Sellers harmless from any violation of the foregoing.

7. *Right of Sellers to Reject Subscription.* The Subscriber understands and agrees that the Sellers reserve the absolute right to reject any subscription received for, among other reasons, failure to satisfy any of the conditions of this subscription, insufficient documentation, over-subscription to the offering, or such other reasons as the seller determines to be in the best interests of the Company in their sole discretion. Upon acceptance of this subscription, the Sellers will forward to the Subscriber a copy of his Signature Page signed by the Sellers signifying acceptance of his subscription.

8. *Legends Restricting Transferability.* The Subscriber agrees that any instrument that may be issued to evidence ownership of the Shares will be imprinted with a conspicuous legend stating that the Shares have not been registered under the 1933 Act or any State securities laws, and referring to the restrictions on the assignability of the Shares.

9. IN WITNESS WHEREOF, the undersigned executes and agrees to be bound by this Subscription Agreement by executing and delivering a Signature Page in the form attached hereto on the date therein indicated.

No. _____

In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

CALVIN KLEIN, GEORGE E. LAYMAN, JR., GEORGE E. LAYMAN, ZENYA YOSHIDA, DBA SHADAI FARMS, KENNETH FRANZHEIM, II, BLAS R. CASARES, EARL H. SHULTZ, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, H. JAMES GRIGGS, BARRY K. SCHWARTZ, FOREST ACRES PARTNERSHIP, a Washington State General Partnership, BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership and ROBERT D. STRATMORE,

RESPONDENTS.

PROOF OF SERVICE BY MAIL

State of California

ss.

County of Los Angeles

I, the undersigned, say: I am and was at all times herein mentioned, a citizen of the United States and a resident of the County of Los Angeles, over the age of

eighteen (18) years and not a party to the within action or proceeding; that my business address is 9105 Sunset Boulevard, West Hollywood, California 90069; that on August 9, 1993, I served the within *Appendices To Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit* in said action or proceeding on all parties required to be served by depositing true copies thereof, enclosed in a sealed envelope with first class postage thereon fully prepaid, in the United States mail at Los Angeles, California, addressed as follows:

Clerk, United States Supreme Court
One First Street, N.E.
Washington, D.C. 20543
(*By Express Mail: Original and Forty Copies*)

Clerk, United States Court of Appeals
Ninth Judicial Circuit
121 Spear Street
San Francisco, California 94119-3939
(Three Copies)

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P.O. Box 7880
San Francisco, California 94120-7880
Counsel for Zenya Yoshida, dba
Counsel for Zenya Yoshida, dba
(Three Copies)

I declare under penalty of perjury that the foregoing is true and correct. Executed on August 9, 1993, at Los Angeles, California.

Betty J. Malloy
(Original Signed)

No. 93-214

Supreme Court, U.S.
FILED
SEP - 9 1993
OFFICE OF THE CLERK

In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN-EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

GEORGE E. LAYMAN, JR. DBA FOREST ACRES PARTNERSHIP, a Washington State Partnership, BARRY K. SCHWARTZ and CALVIN KLEIN DBA BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership, ZENYA YOSHIDA DBA SHADAI FARM, KENNETH FRANZHEIM, II, H. JAMES GRIGGS, EARL H. SHULTZ, BLAS R. CASARES, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, and ROBERT D. STRATMORE,

RESPONDENTS.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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Attorneys for Respondents

* Counsel of Record

QUESTION PRESENTED FOR REVIEW

Whether, in applying California state law applicable to the construction of contracts, the Court of Appeals properly affirmed the district court's interpretation that, under a contract executed by respondents to subscribe to purchase private placement stock, respondents did not agree to indemnify the sellers for attorneys' fees in the event that respondents should unsuccessfully sue the sellers for violation of the federal securities law.

TABLE OF AUTHORITIES

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Cases

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B. Statement of facts.

1. The private placement of Spendthrift stock.

Spendthrift Farm, based in Lexington, Kentucky and recognized as one of the world's leading thoroughbred horse farms in the 1970's and early 1980's, was founded, owned and operated by Leslie Combs and his son, Brownell Combs. In early 1983, the Combses devised a plan to sell $35 million worth of their own Spendthrift stock in a private offering and, shortly afterward, raise an additional $30 million for the company in a public offering. The Combses hired petitioners Charles Hembree and Kincaid, Wilson, Schaeffer & Hembree (hereinafter the "Kincaid firm") as securities counsel, petitioner Frank Bryant as a consultant to advise on the private and public stock offering, and Kemper Securities, Inc. (formerly Bateman Eichler, Hill Richards, Inc.) to review the private offering and underwrite the public offering.

Beginning in April 1983, the Combses offered their Spendthrift stock in 20 equal units, each valued at $1.75 million, to investors around the world. The Combses' stock was not registered with the Securities and Exchange Commission (hereinafter the "SEC"). Instead, the Combses represented to respondents and other investors that the offering was a "private placement," exempt from registration under section 4(1) of the Securities Act of 1933

(15 U.S.C. § 77d) and Regulation D (17 C.F.R. § 230.501, et seq.) promulgated thereunder.[1]

In order to comply with the private placement exemption, the Combses had to ensure that investors satisfied the "sophistication" requirements of Regulation D. These requirements include, inter alia, a minimum net worth, knowledge and experience in investment matters, a capability of evaluating the risks and merits of the investment, access to the issuer's books and records, a purchase with no view to resale, and an opportunity to ask questions and receive answers. See 17 C.F.R. §§ 230.501, 502 & 506 (Resp App. at A2-A18).

During the spring and summer of 1983, the Combses sent an offering prospectus, entitled Private Placement Memorandum (hereinafter "PPM"), to respondents and other prospective investors. The PPM provided that:

> SUITABILITY STANDARDS: The Sellers will impose certain standards which prospective investors must meet in order to be eligible to purchase the shares. These suitability standards are designed to assure compliance with section 4(1) of the Securities Act of 1933 and Regulation D promulgated by the Securities

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1 Section 4(1) of the Securities Act of 1933 (15 U.S.C. § 77d(1)) and Regulation D (17 C.F.R. § 230.501 et seq.) are reproduced, in relevant part, in Respondents' Appendix (hereinafter "Resp App.") at pages A1-A18.

> and Exchange Commission thereunder and with the Blue Sky Laws of the states in which this offering will be made.
>
> . . . .
>
> In order to ensure compliance with the foregoing suitability standards, each prospective purchaser will be required to execute a Subscription Agreement (a copy of which appears in this offering memorandum as Appendix D-4) containing a representation that he meets the suitability standards.[2]

By signing the Subscription Agreement, each investor represented, inter alia, that the investor (1) was financially able to bear the economic risk of the investment, (2) had a net worth in excess of $5 million, (3) had read the PPM, (4) had an opportunity to review Spendthrift's books and records, (5) was capable of

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2 Similarly, the Purchaser Questionnaire completed by each investor provided that:

> The information contained herein is being furnished to Leslie Combs II and Brownell Combs II, the sellers of shares in Spendthrift Farm, Inc., a Kentucky Corporation, for the purpose of determining whether the undersigned's subscription for shares in the Company may be accepted pursuant to Section 4(1) of the Securities Act of 1933, as amended (the "Act"), and Rule 506 promulgated by the Securities and Exchange Commission thereunder ("Rule 506"). The undersigned understands that (i) the sellers of the shares will rely upon the following information, (ii) the shares will not be registered under the Act in reliance upon the exemption from registration provided by Section 4(1) of the Act and Rule 506, and (iii) this Questionnaire is not an offer to sell nor the solicitation of an offer to buy any of the shares, or any other securities, to the undersigned.

evaluating the risks and merits of the deal, (6) was given an opportunity to ask questions and receive answers from the Combses, and (7) was purchasing shares for his own account and not with a view to resale. See Pet App. at A73-77.[3]

The Subscription Agreement expressly recited that the Combses were relying upon the subscribers' representations for the registration exemption. Id. at A75. And each respondent further represented that:

> [H]e understands that in [sic] view of the Securities and Exchange Commission (the "Commission") the statutory basis for the exemption claimed would not be present if, notwithstanding each investor's representations and warranties, any of the investors has in mind merely acquiring any of the Units for resale upon the occurrence of [sic] non-occurrence of some predetermined event or if any investor is not financially responsible.

Id.

The indemnity clause, the interpretation of which was at issue below, followed. It provided in full that:

> The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber

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3 Prior to 1982, private stock offerings exempt from registration under the federal securities law were governed by SEC Rule 146. In 1982, the SEC adopted Regulation D, which defines an accredited investor, inter alia, as an IRC 501(a)(3) tax-exempt organization with total assets in excess of $5 million or an individual with a net worth in excess of $1 million. 17 C.F.R. § 230.501(a) (Resp App. at A2-A4).

> hereby agrees that such representations and warranties shall survive his purchase thereof. The Subscriber hereby agrees to indemnify and hold harmless the Company, the Sellers and agents of each of them from and against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements), judgments and amounts paid in settlement resulting from the untruth of any of the warranties and representations contained herein, or the breach by the Subscriber of any of the covenants made by him herein. Notwithstanding the foregoing, however, no representation, warranty, acknowledgment, or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

Id. at A78.

The only signatories to the Subscription Agreement were the sellers, Leslie Combs and Brownell Combs, and the subscribers. Petitioners Bryant, Kemper Securities, Charles R. Hembree and the Kincaid firm were neither parties nor signatories to the agreement.

2. The securities fraud lawsuits.

In 1986, respondents filed securities fraud lawsuits, alleging that the Combses, petitioners Hembree, the Kincaid firm, Bryant and Kemper Securities misrepresented and omitted material facts in connection with the sale of Spendthrift stock. Respondents settled with Leslie Combs for $2 million. The district court granted summary judgment in favor of petitioners Bryant and Kemper Securities, and it directed a verdict in favor of petitioners Hembree and the Kincaid firm. The jury returned a verdict in

favor of Brownell Combs. The Ninth Circuit affirmed. McGonigle v. Combs, 968 F.2d 810 (9th Cir. 1992).

In response to the complaint below, petitioners filed compulsory counterclaims for attorney's fees under the Subscription Agreement.[4] The Combses, the actual sellers of the stock, filed no such counterclaims.[5]

C. The decisions below.

Petitioners' claim for attorney's fees under the Subscription Agreement is not, and never has been, based on the loss of any private placement exemption. Rather, it is based solely on the claim that respondents, by alleging misrepresentations and

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4 Petitioners also requested attorneys' fees pursuant to Section 11(e) of the 1933 Securities Act (15 U.S.C. § 77k(e)). The district court denied that request on the ground that respondents' securities fraud lawsuit was neither frivolous nor filed in bad faith. The Ninth Circuit agreed that the lawsuits were neither frivolous nor filed in bad faith, but remanded on the narrow issue of whether the court had considered the Ninth Circuit standard of "bordering on the frivolous" with respect to petitioner Bryant. Layman, 994 F.2d at 1353 & n.7 (Pet App. at A20-A21).

5 Following trial, Brownell Combs requested leave to amend to file a similar compulsory counterclaim but the California district court denied the request. Stratmore, 723 F. Supp. at 459-60, 463-64 (Pet App. at A39-40, A50). One year later, Brownell filed a separate action against respondent Yoshida for attorney's fees under the Subscription Agreement in the United States District Court for the Eastern District of Kentucky. See Combs v. Yoshida, No. 90-131 (E.D. Ky. 1993) (Pet App. at A51-A60). The Kentucky district court, over the strenuous objection of respondent Yoshida, permitted the case to proceed as a separate action despite the compulsory nature of the claim in the original California action.

omissions of material facts in the underlying securities fraud complaint, purportedly breached the representations of the Subscription Agreement.[6]

The district court rejected petitioners' interpretation of the Subscription Agreement, observing that the intent of the indemnification paragraph, as expressly set forth in its first sentence, "is to protect Spendthrift and the selling shareholders from the consequences of a plaintiff being unqualified, or the shares being unsuitable for his investment, and hence the private placement being lost." Stratmore, 723 F. Supp. at 461 (Pet App. at A43).

The district court ruled that, in view of the language on the face of the Subscription Agreement, "[respondents] had little reason to anticipate that the indemnity provision would apply to suits by the buyers themselves against the sellers for securities act violations." Id. at 463 (Pet App. at A49). Accordingly, as a simple matter of contract interpretation, the district court held that:

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6 In considering the summary judgment motions, the district court "assume[d] that the representations or warranties alleged by defendants were breached by plaintiffs." Stratmore, 723 F. Supp at 460 (Pet App. at A42). The Ninth Circuit made the same assumption for purposes of argument. Layman, 994 F.2d at 1350 (Pet App. at A13). Respondents do not agree that there was any breach of the representations or warranties of the Subscription Agreement. For purposes of the summary judgment motion, however, respondents argued below that even assuming a breach, petitioners were not entitled to attorneys' fees.

> [T]he indemnity clause here did not explicitly provide that plaintiffs would be liable for defendants' attorneys' fees in the event of an unsuccessful securities lawsuit by plaintiffs, and the clause therefore may not be enforced in that manner.

Id. (Pet App. at A50).

The Court of Appeals affirmed. Applying California state law of contract interpretation, the Court concluded that:

> [T]he unambiguous expressed intent of the [indemnity] clause is that any investor whose breach of a representation causes the sellers to lose their private placement exemption is obligated to reimburse the sellers for their losses. In our view, a reasonable investor who read the PPM and the subscription agreement would so interpret the indemnification clause.

Layman, 994 F.2d at 1351, 1350 n.3 (footnote omitted) (Pet App. at A15, A13).

The dissenting judge, arguing that the Court had misconstrued the California law of contract interpretation, asserted that "California law is just the opposite" of that applied by the majority. Id. at 1355 (Pet App. at A25). According to the dissent, under California law, a party may submit its interpretation of an agreement to a jury "[e]ven if the language seems susceptible to only one meaning." Id. (Pet App. at A26).

REASONS WHY WRIT SHOULD BE DENIED

I. NO FEDERAL QUESTION IS INVOLVED IN THE CONSTRUCTION OF THE SUBSCRIPTION AGREEMENT.

A. The sole issue presented is one of contract interpretation under state law.

The only issue presented by the petition is whether the Ninth Circuit, in applying California law, properly construed the Subscription Agreement between respondent subscribers and the sellers of Spendthrift stock, Leslie and Brownell Combs. The Ninth Circuit itself framed the issue: "Does the indemnification clause obligate the plaintiffs, who are assumed to have breached their warranties, to pay the attorneys' fees of the defendants that were incurred in defending the plaintiffs' unsuccessful claims?" Layman, 994 F.2d at 1350 (Pet App. at A13).

The Ninth Circuit, upon a review of the express language of the Subscription Agreement, concluded that "the unambiguous expressed intent of the clause is that any investor whose breach of a representation causes the sellers to lose their private placement exemption is obligated to reimburse the sellers for their losses." Id. at 1351 (emphasis added) (Pet App. at A15). "[T]he indemnification required by the clause in this case does not extend

to fees or damages incurred in defending claims brought by the subscribing indemnitor." Id. at 1353 (Pet App. at A19).

The dissenting opinion, upon which petitioners place great reliance, actually underscores the limited nature of the issues decided below. Judge Kozinski argued that, in interpreting the Subscription Agreement, the majority applied law that is the "opposite" of California law. Layman, 994 F.2d at 1355 (Pet App. at A25). Judge Kozinski disagreed that the Subscription Agreement was, on its face, unambiguous, and asked rhetorically "Are we free to interpret the contract--and declare that no rational trier of fact could do otherwise--so as to render this [attorney fee] warranty a nullity?" Id. at 1356 (Pet App. at A27).[7]

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7 The dissent appears to be based in large part upon its misunderstanding of California law. First, under California law, a jury question does not arise simply because a written agreement may be subject to varying interpretations. When, as here, there is no conflict in the extrinsic evidence, "it is 'a judicial function to interpret a written instrument.'" Estate of Dodge, 6 Cal. 3d 311, 318 (1971). Indeed, "[t]he very possibility of . . . conflicting interpretations, far from relieving the appellate court of the responsibility of interpretation, signalizes the necessity of its assuming that responsibility." Parson v. Bristol Development Co., 62 Cal. 2d 861, 866 n.2 (1965). Second, contrary to Judge Kozinski's view that any evidence of meaning is relevant even if the agreement does not appear to be susceptible to that interpretation (see Layman, 994 F.2d at 1355 (Pet App. at A26)), "a court is not required to accept implausible or semantically impermissible claims of meaning." FPI Development, Inc. v. Nekashima, 231 Cal. App. 3d 367, 390 n.10 (1991). For these reasons, a California court expressly criticized Judge Kozinski's "unrestrained view of the California law" of parol evidence, as set forth in a prior opinion. Id. at 389-90 n.10.

For the reasons discussed in the section that follows, respondents submit that the interpretation of the Subscription Agreement by both courts below is correct. But even if the dissent were correct, no issue is presented under the 1933 Securities Act, the 1934 Exchange Act or any other federal law. Although this contract dispute arose in the context of an action under the federal securities, it remains solely a contract dispute--no more, no less.[8]

B. The Ninth Circuit's interpretation of the indemnity provision is correct.

Respondents submit that the above discussion is determinative of this matter: Regardless of whether the Ninth Circuit reached a correct result, no federal issue is presented. Nonetheless, because petitioners present misleading and erroneous argu-

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8 One federal question was decided below. Section 11(e) of the Securities Act of 1933 provides that costs may be awarded for the filing of a securities lawsuit if "the court believes that the suit or the defense thereto have been without merit . . . ." 15 U.S.C. § 77k(e) (Pet App. at A66). The district court denied petitioners' requests for costs under section 11(e), ruling that the claims were neither frivolous nor filed in bad faith. See Stratmore, 723 F. Supp. at 460, n.2 (Pet App. at A40). Petitioner Bryant alone appealed this ruling. The Ninth Circuit agreed that none of the claims against Bryant were frivolous or filed in bad faith, but it remanded on the narrow issue whether the district court had properly considered the Ninth Circuit's "bordering on the frivolous" standard. Layman, 994 F.2d at 1353 & n.7 (Pet App. at A20-A21). Neither the section 11(e) issue, nor any other federal question, is presented to this Court for review.

ments regarding the interpretation issue, respondents will briefly answer those arguments.

The context of the indemnity provision (paragraph 5 of the Subscription Agreement) is critical here. The first page of the PPM, of which the Subscription Agreement is an appendix, provides that:

> [T]he sellers [Leslie and Brownell Combs] will impose certain standards that prospective investors must meet in order to be eligible to purchase the shares. These suitability standards are designed to ensure compliance with Section 4(i) of the Securities Act of 1933 and Regulation D promulgated by the Securities and Exchange Commission thereunder and with the Blue Sky Laws of the states in which the offering will be made.

Layman, 994 F.2d at 1350 (Pet App. at A13).

The indemnity provision itself consists of three sentences which, when read together and in the context of the entire document, show that petitioners' duty to indemnify the Combses and their agents is limited to representations that result in a loss of the registration exemption. This conclusion is based solely upon the express language of the document.

Respondents made representations in the Subscription Agreement for the express purpose of allowing the Combses to claim a registration exemption. The PPM provides that the suitability standards set forth in the Subscription Agreement "are designed to ensure compliance with section 4(1) and Rule 506 promulgated

thereunder."[9] This is expressly confirmed by the first sentence of paragraph 5:

> The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber hereby agrees that such representations and warranties shall survive his purchases thereof.

Pet App. at A78.

Notably, the second sentence of paragraph 5 contains no agreement that any breach of the representations and warranties by respondents would subject them to payment of costs for filing their own lawsuit based on the sellers' misrepresentations and omissions of material facts in connection with the stock sale. As a practical matter, respondents could not have so agreed. They did not know, and certainly did not believe, that the Combses and their agents misrepresented or omitted material facts. If they had, petitioners would not have invested in the first place.

The third sentence of paragraph 5 is consistent with this point:

> No representation, warranty, acknowledgment, or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

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9 Indeed, the Ninth Circuit properly noted that "the representations in the subscription agreement track, verbatim, the language of Regulation D." Layman, 994 F.2d at 1351 (Pet App. at A13-A14).

Pet App. at A78. Respondents did not waive their right to file a lawsuit for misrepresentations and omissions of material facts.

Under these circumstances, and in view of the context of the language at issue, the Ninth Circuit was correct in concluding that the second sentence of paragraph 5 is limited to situations involving a loss of the registration exemption. There is no basis upon which to conclude that respondents agreed to the expansive reading advanced by petitioners.

Petitioners, in an attempt to transmute this fact-specific case of contract interpretation into a federal question, assert that the Ninth Circuit relied upon a "special standard of narrow construction against sellers of securities whenever buyers allege federal securities claims." Petition ("Pet.") at i. In support of this assertion, petitioners refer to the Ninth Circuit's citation of the Second Circuit's opinion in Zissu v. Bear Stearns & Co., 805 F.2d 75 (2d Cir. 1986). That citation, however, affords no support to petitioners' position. After utilizing basic principles of contract construction to rule that the Subscription Agreement was unambiguous on its face, the Ninth Circuit observed:

> Our reading of Zissu is that a reference to attorneys' fees is necessary but not sufficient; the crucial element of an indemnification is that it put potential investors on notice that the indemnification is not limited, and instead applies to fees and damages incurred in defending a claim brought by the subscribing indemnitor

herself. The placement of the indemnifying language, as well as the language itself, must reveal its scope.

Layman, 994 F.2d at 1352 (Pet App. at A17). The Ninth Circuit nowhere referred to any "standard of narrow construction against sellers of securities." Petitioners' effort to manufacture a federal question is in vain.

II. THERE IS NO CONFLICT BETWEEN THE CIRCUIT COURTS REGARDING THE CONSTRUCTION OF INDEMNITY FEE PROVISIONS IN PRIVATE PLACEMENT SUBSCRIPTION AGREEMENTS.

The Second Circuit, the only other Circuit Court to interpret an attorneys' fee provision of a subscription agreement, reached the same result as the Ninth Circuit. In Zissu v. Bear, Stearns & Co., 805 F.2d 75 (2d Cir. 1986), an investor who had made representations and warranties in a subscription agreement filed a lawsuit for securities fraud. Id. at 76. The subscription agreement, similar to the one in this case, provided that the investor would indemnify and hold harmless the sellers for any breach of the representations or warranties. Id. at 77. The agreement also provided, just as the one in this case, that the investor did not waive any of his rights under the securities laws. Id.

The defendants prevailed in the underlying action and requested costs, including reasonable attorneys' fees, under the subscription agreement. Id. at 79. The Second Circuit denied the request applying basic principles of contract construction:

> [T]he warranties in question were necessary to exempt the limited partnership from the requirements of the 1933 Act and are so understood by investors. That being the case, the parties had little reason to expect that such warranties might also be the basis for the counterclaim made in the present case.

Id. Based upon the express language of the subscription agreement, and the New York law of contract construction, the Second Circuit concluded "the indemnity provision is not sufficiently specific to hold [the investor] liable for defendant's costs." Id. at 78.

The Ninth Circuit confirmed that the circuit courts are in accord, observing that its contract analysis "comports with [Zissu] the leading case on the application of indemnification clauses." Layman, 994 F.2d at 1351 (Pet App. at A15). Petitioners nonetheless maintain that "the 'prime reason' certiorari is appropriate in this case is the conflict between certain recent circuit opinions." Pet. at 13. In this regard, petitioners refer to Samuels v. Wilder, 871 F.2d 1346 (7th Cir. 1989), which in fact confirms the accord among the circuits that state law is to be applied. In Samuels, the

district court had interpreted a broad indemnity provision in a nominee agreement. Id. at 1348. As the Seventh Circuit observed:

> [A]fter a thorough analysis of applicable New York law, the district court concluded that the indemnity clause required the 'owner' (here the plaintiffs) to pay the litigation costs incurred by [defendant's nominee] when defending this lawsuit.

Id. at 1351. The Seventh Circuit affirmed, concluding that the district court had correctly applied New York law. Id.[10]

The only reported district court decision referred to by petitioners, Barneby v. E.F. Hutton & Co., 587 F. Supp. 829 (M.D. Fla. 1989), is inapposite. There, the district court denied the plaintiff's motion for summary judgment on the defendant's counterclaim for costs under a subscription agreement, ruling that:

> Defendants only seek indemnity for fees and costs incurred in defending against plaintiffs' nonmeritorious claims which have triggered the indemnity clause.

715 F. Supp. at 1520.

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10 Petitioners' reliance on Atari Corp. v. Ernst & Whinney, 981 F.2d 1025 (9th Cir. 1992) and Tartell v. Chelsea Nat'l Bank, 470 F.2d 994 (2nd Cir. 1972) is equally misplaced. The Ninth Circuit properly distinguished Atari, noting that under the language of the broad indemnity clause at issue in the case, "losses caused by an action brought by the indemnitor" were covered. Layman, 994 F.2d at 1353 (Pet App. at A23). In Tartell, the Second Circuit simply issued a one-sentence per curiam decision affirming the district court. 470 F.2d at 994. The district court opinion, applying the applicable New York law of contract construction, concluded that defendant bank was entitled to attorney's fees under the express language of the bank note at issue in the case. Tartell v. Chelsea National Bank, 351 F. Supp. 1071, 1079 (S.D.N.Y. 1972).

Respondents do not dispute that, when securities claims lack merit, in violation of section 11(e), the defendants can be awarded costs. But, that is not present in this case.[11]

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11 Petitioners also rely (Pet., pp. 2-3, 4, 21, 22-24) on the unreported decision of the Kentucky district court in the action brought there by Brownell Combs on the same agreement involved herein. See Combs v. Yoshida, No. 90-131 (E.D. Ky. 1993) (Pet App. at A51-A60). In that decision, the district court held that, because the agreement (in its view) was subject to various interpretations on its face, "the applicability of the indemnity clause is an issue for the trier of fact." Pet App. at A59-A60. Respondents disagree with this conclusion. However, even if it were correct, it is apparent that it results from application of rules of contract interpretation that differ from California's law. See discussion supra, p. 8, n.5. Hence, any "conflict" or "inconsistency" (see Pet. at 21-26) results from federal courts in different districts applying different state law. This is a result inherent in the federal system, not from any conflict in interpretation of federal law.

CONCLUSION

For the reasons stated above, respondents respectfully submit that the petition for writ of certiorari should be denied.

Dated: September 9, 1993.

Respectfully submitted,

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APPENDIX

The Securities Act of 1933, Section 4(1) & (2) (15 U.S.C. § 77d(1) & (2)) (1993):

§ 77d. Exempted transactions.

The provisions of section 5 . . . shall not apply to--

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

* * *

SEC Rules 501, 502 & 506, commonly referred to as Regulation D (17 C.F.R. § 230.501, 502 & 506) (1993):

§ 230.501 Definitions and terms used in Regulation D.

As used in Regulation D (§§ 230.501-230.508), the following terms shall have the meaning indicated:

(a) *Accredited investor.* *Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency

or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); and

(8) Any entity in which all of the equity owners are accredited investors.

(b) *Affiliate.* An *affiliate* of, or person *affiliated* with, a specified person shall mean a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.

(c) *Aggregate offering price. Aggregate offering price* shall mean the sum of all cash, services, property, notes, cancellation of debt, or other consideration to be received by an issuer for issuance of its securities. Where securities are being offered for both cash and non-cash consideration, the aggregate offering

price shall be based on the price at which the securities are offered for cash. Any portion of the aggregate offering price attributable to cash received in a foreign currency shall be translated into United States currency at the currency exchange rate in effect at a reasonable time prior to or on the date of the sale of the securities. If securities are not offered for cash, the aggregate offering price shall be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard. Such valuations of non-cash consideration must be reasonable at the time made.

(d) *Business combination.* *Business combination* shall mean any transaction of the type specified in paragraph (a) of Rule 145 under the Act (17 CFR 230.145) and any transaction involving the acquisition by one issuer, in exchange for all or a part of its own or its parent's stock, of stock of another issuer if, immediately after the acquisition, the acquiring issuer has control of the other issuer (whether or not it had control before the acquisition).

(e) *Calculation of number of purchasers.* For purposes of calculating the number of purchasers under §§ 230.505(b) and 230.506(b) only, the following shall apply:

(1) The following purchasers shall be excluded:

(i) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;

(ii) Any trust or estate in which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interests);

(iii) Any corporation or other organization of which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(ii) of this section collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and

(iv) Any accredited investor.

(2) A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor under paragraph (a)(8) of this section, then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D (§§ 230.501-230.508), except to the extent provided in paragraph (e)(1) of this section.

(3) A non-contributory employee benefit plan within the meaning of Title I of the Employee Retirement Income Security

Act of 1974 shall be counted as one purchaser where the trustee makes all investment decisions for the plan.

(f) *Executive officer.* *Executive officer* shall mean the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy making functions for the issuer.

(g) *Issuer.* The definition of the term *issuer* in section 2(4) of the Act shall apply, except that in the case of a proceeding under the Federal Bankruptcy Code (11 U.S.C. 101 *et seq.*), the trustee or debtor in possession shall be considered the issuer in an offering under a plan or reorganization, if the securities are to be issued under the plan.

(h) *Purchaser representative.* *Purchaser representative* shall mean any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions:

(1) Is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any

class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the purchaser is:

(i) A relative of the purchaser representative by blood, marriage or adoption and not more remote than a first cousin;

(ii) A trust or estate in which the purchaser representative and any persons related to him as specified in paragraph (h)(1)(i) or (h)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interest) or of which the purchaser representative serves as trustee, executor, or in any similar capacity; or

(iii) A corporation or other organization of which the purchaser representative and any persons related to him as specified in paragraph (h)(1)(i) or (h)(1)(ii) of this section collectively are the beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interest;

(2) Has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment;

(3) Is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative in

connection with evaluating the merits and risks of the prospective investment; and

(4) Discloses to the purchaser in writing a reasonable time prior to the sale of securities to that purchaser any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

. . . .

§ 230.502 General conditions to be met.

The following conditions shall be applicable to offers and sales made under Regulation D (§§ 230.501-230.508):

(a) *Integration.* All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those

offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act (17 CFR 230.405).

. . . .

(b) *Information requirements--(1) When information must be furnished.* If the issuer sells securities under § 230.505 or § 230.506 to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) of this section to such purchaser a reasonable time prior to sale. The issuer is not required to furnish the specified information to purchasers when it sells securities under § 230.504, or to any accredited investor.

(2) *Type of information to be furnished.* (i) If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, at a reasonable time prior to the sale of securities the issuer shall furnish to the purchaser the following information, to the extent material to an understanding of the issuer, its business, and the securities being offered:

(A) *Offerings up to $2,000,000.* The same kind of information as would be required in Part II of Form I-A (17 CFR 239.90), except that the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited.

(B) *Offerings up to $7,500,000.* The same kind of information as would be required in Part I of Form S-18 (17 CFR

239.28), except that only the financial statements for the issuer's most recent fiscal year must be certified by an independent public or certified accountant. If Form S-18 is not available to an issuer, then the issuer shall furnish the same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled to use, except that only the financial statements for the most recent two fiscal years prepared in accordance with generally accepted accounting principles shall be furnished and only the financial statements for the issuer's most recent fiscal year shall be certified by an independent public or certified accountant. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

(C) *Offerings over $7,500,000.* The same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled

to use. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

(D) If the issuer is a foreign private issuer, the issuer shall disclose the same kind of information required to be included in a registration statement filed under the Act on the form that the issuer would be entitled to use. The financial statements need be certified only to the extent required by paragraph (b)(2)(i) (B) or (C) of this section, as appropriate.

(ii) If the issuer is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, at a reasonable time prior to the sale of securities the issuer shall furnish to the purchaser the information specified in paragraph (b)(2)(ii)(A) or (B) of this section, and in either event the information specified in paragraph (b)(2)(ii)(C) of this section:

(A) The issuer's annual report to shareholders for the most recent fiscal year, if such annual report meets the requirements of § 240.14a-3 or 240.14c-3 under the Exchange Act, the definitive proxy statement filed in connection with that annual report, and, if requested by the purchaser in writing, a copy of the issuer's most recent Form 10-K (17 CFR 249.310) under the Exchange Act.

(B) The information contained in an annual report on form 10-K under the Exchange Act or in a registration statement on Form S-1 (17 CFR 239.11), Form S-11 (17 CFR 239.18), or Form S-18 (17 CFR 239.28) under the Act or on Form 10 (17 CFR 249.210) under the Exchange Act, whichever filing is the most recent required to be filed.

(C) The information contained in any reports or documents required to be filed by the issuer under sections 13(a), 14(a), 14(c), and 15(d) of the Exchange Act since the distribution or filing of the report or registration statement specified in paragraphs (b)(2)(ii) (A) or (B), and a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs that are not disclosed in the documents furnished.

(D) If the issuer is a foreign private issuer, the issuer may provide in lieu of the information specified in paragraph (b)(2)(ii)

(A) or (B) of this section, the information contained in its most recent filing on Form 20-F or Form F-1 (§ 23931 of the chapter).

(iii) Exhibits required to be filed with the Commission as part of a registration statement or report, other than an annual report to shareholders or parts of that report incorporated by reference in a Form 10-K report, need not be furnished to each purchaser that is not an accredited investor if the contents of material exhibits are identified and such exhibits are made available to a purchaser, upon his written request, a reasonable time prior to his purchase.

(iv) At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under § 230.505 or § 230.506, the issuer shall furnish to the purchaser a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser. The issuer shall furnish any portion or all of this information to the purchaser, upon his written request a reasonable time prior to his purchase.

(v) The issuer shall also make available to each purchaser at a reasonable time prior to his purchase of securities in a transaction under § 230.505 or § 230.506 the opportunity to ask questions and receive answers concerning the terms and conditions of

the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished under paragraph (b)(2) (i) or (ii) of this section.

(vi) For business combinations or exchange offers, in addition to information required by Form S-4 (17 CFR 239.25), the issuer shall provide to each purchaser at the time the plan is submitted to security holders, or, with an exchange, during the course of the transaction and prior to sale, written information about any terms or arrangements of the proposed transactions that are materially different from those for all other security holders. For purposes of this subsection, an issuer which is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act may satisfy the requirements of Part I.B. or C. of Form S-4 by compliance with paragraph (b)(2)(i) of this § 230.502.

(vii) At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under § 230.505 or § 230.506, the issuer shall advise the purchaser of the limitations on resale in the manner contained in paragraph (d)(2) of this section. Such disclosure may be contained in other materials required to be provided by this paragraph.

(c) *Limitation on manner of offering.* Except as provided in § 230.504(b)(1), neither the issuer nor any person acting on its

behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

(d) *Limitations on resale.* Except as provided in § 230.504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom. The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(11) of the Act, which reasonable care may be demonstrated by the following:

(1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;

(2) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and

(3) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities. While taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care. Other actions by the issuer may satisfy this provision. In addition, §§ 230.502(b)(2)(vii) and 230.504(b)(2)(ii) require the delivery of written disclosure of the limitations on resale to investors in certain instances.

. . . .

§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.

(a) *Exemption.* Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.

(b) *Conditions to be met--(1) General conditions.* To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 and 230.502.

(2) *Specific Conditions--(i) Limitation on number of purchasers.* There are no more than or the issuer reasonably believes

that there are no more that 35 purchasers of securities from the issuer in any offering under this section.

. . . .

(ii) *Nature of purchasers.* Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.